SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1927

No. 978 / 129

THE UNITED STATES OF AMERICA

vs.

BOSTON & MAINE RAILROAD

No. 979

OLD COLONY TRUST COMPANY ET AL., EXECUTORS

vs.

COMMISSIONER OF INTERNAL REVENUE

ON CERTIFICATE FROM THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

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1 In United States Circuit Court of Appeals for the First Circuit

October Term, 1927

No. 2235

UNITED STATES OF AMERICA, DEFENDANT, APELLANT,

v.

BOSTON & MAINE RAILROAD, PLAINTIFF, APPELLEE

Appeal from the District Court of the United States for the District of Massachusetts

Before BINGHAM, JOHNSON, and MORTON, JJ.

No. 2218

OLD COLONY TRUST COMPANY ET AL., EXECUTORS, PETITIONERS FOR review

v.

COMMISSIONER OF INTERNAL REVENUE

Petition for review of decision of United States Board of Tax Appeals

Before BINGHAM, JOHNSON, AND HALE, JJ.

Question of law certified by the United States Circuit Court of Appeals for the First Circuit to the Supreme Court of the United States May 2, 1928

Statement of facts

The facts in No. 2235 are as follows:

This action is brought by the Boston & Maine Railroad to recover income taxes for the year 1917, claimed to have been erroneously collected. In the District Court the plaintiff recovered a judgment for the full amount of its demand—$3,920.55 and interest.

2

June 30, 1900, the Fitchburg Railroad Company leased all its railroad and property of every description to the Boston & Maine Railroad for the term of ninety-nine years. In the lease the lessee covenanted to pay specified rentals, to maintain and replace the leased properties in manner indicated, to pay all operating expenses, and to pay "all taxes of every description, Federal, State, and municipal, upon the lessor's property, business, indebtedness, income,

franchises, or capital stock, or said rental," and to pay divers other charges. In 1918 an income-tax return, under the provisions of the revenue acts of 1916 and 1917, was filed on behalf of the Fitchburg Railroad Company for the calendar year 1917, upon which taxes amounting to $61,422.06 were assessed. These taxes were paid to the Commissioner of Internal Revenue by the Boston & Maine Railroad pursuant to the term of the lease. The Fitchburg Railroad Company was consolidated with the Boston & Maine Railroad in 1919.

In 1921 the Commissioner of Internal Revenue assessed an additional income tax against the Fitchburg Railroad Company of $3,920.55. In doing this he treated the payment of $61,422.06 made by the Boston & Maine Railroad to the collector of internal revenue as additional taxable income to the Fitchburg Railroad Company to the extent of $65,342.61. This additional tax of $3,920.55 was paid to the collector of internal revenue by the Boston & Maine Railroad in July, 1921.

The claim for refund of this additional tax was duly filed with the Commissioner of Internal Revenue, but was never formally acted upon, and more than six months having elapsed after it was filed, this action was brought for the recovery of the tax so paid.

The facts in No. 2218 are as follows:

This is a petition to review a decision of the United States Board of Tax Appeals. The petitioners are the executors of the will of
3 William M. Wood, deceased. The Board of Tax Appeals found a deficiency in the Federal income tax of Mr. Wood for the year 1919 of $708,781.93 and for the year 1920 of $350,837.14. The petition for review was duly filed pursuant to sections 1001 and 1002 of the revenue act of 1926 and rule 38 of this court.

William M. Wood was president of American Woolen Company during the years of 1918, 1919, and 1920. In 1918 he received as salary and commissions from the company $978,725, which he included in his Federal income tax return for 1918. In 1919 he received as salary and commissions from the company $548,132.87, which he included in his Federal income tax return for 1919.

August 3, 1916, the American Woolen Company duly adopted the following resolution, which was in effect in 1919 and 1920:

"Voted: That this company pay any and all income taxes, State and Federal, that may hereafter become due and payable upon the salaries of all the officers of the company, including the president, William M. Wood; the comptroller, Parry C. Wiggin; the auditor, George R. Lawton; and the following members of the staff, to wit: Frank H. Carpenter, Edwin L. Heath, Samuel R. Haines, and William M. Lasbury, to the end that said persons and officers shall receive their salaries or other compensation in full without deduction on account of income taxes, State or Federal, which taxes are to be paid out of the treasury of this corporation."

This resolution was amended on March 25, 1918, as follows:

"Voted: That, referring to the vote passed by this board on August 3, 1916, in reference to income taxes, State and Federal, payable upon the salaries or compensation of the officers and certain employees of this company, the method of computing said taxes shall be as follows, viz:

"The difference between what the total amount of his tax would be, including his income from all sources, and the amount of his tax when computed upon his income excluding such compensation or salaries paid by this company."

Pursuant to these resolutions the American Woolen Company paid to the collector of internal revenue Mr. Wood's Federal income and surtaxes due to salary and commissions paid him by the company as follows:

4

Taxes for 1918 paid in 1919	$681,169.88
Taxes for 1919 paid in 1920	351,179.27

The decision of the Board of Tax Appeals here sought to be reviewed was that the income taxes of $681,169.88 and $351,179.27 paid by the American Woolen Company for Mr. Wood were additional income to him for the years 1919 and 1920.

Question certified

In view of the foregoing we desire the instruction of the Supreme Court upon the following question:

Did the payment by the lessee in No. 2235 or by the employer in No. 2218 of the income taxes assessable against the lessor in the first case and the employee in the second constitute additional taxable income to such lessor or to such employee?

We are informed that numerous cases are pending in which this question is involved, and because of this we take this action.

It is now, to wit, May 2, 1928, ordered that the foregoing statement of facts, and question of law arising thereon, together with the fact that this court desires the instruction of the Supreme Court for the proper decision of said question of law, be certified under the seal of this court, and transmitted to the Supreme Court.

By the court:

ARTHUR I. CHARRON, *Clerk.*

5 *Clerk's certificate*

And now, here, the judges of the United States Circuit Court of Appeals for the First Circuit certify that the foregoing is a true copy of an order of court entered on May 2, 1928, in said causes numbered and entitled

No. 2235

UNITED STATES OF AMERICA, DEFENDANT, APPELLANT

v.

BOSTON & MAINE RAILROAD, PLAINTIFF, APPELLEE

No. 2218

OLD COLONY TRUST COMPANY ET AL., EXECUTORS, PETITIONERS FOR review

v.

COMMISSIONER OF INTERNAL REVENUE

and that, pursuant to said order, the statement of facts and question of law arising thereon, together with the fact that said Circuit Court of Appeals desires the instruction of the Supreme Court of the United States for the proper decision of said question of law contained in said order, are hereby certified under the seal of said United States Circuit Court of Appeals for transmission to said Supreme Court.

In testimony whereof I hereto set my hand and affix the seal of said United States Circuit Court of Appeals for the First Circuit at Boston, in the First Judicial Circuit, this fourth day of May, A. D. 1928.

[SEAL.] ARTHUR I. CHARRON, *Clerk.*

(Indorsed on cover:) File Nos. 33430, 33431. U. S. Circuit Court of Appeals, First Circuit. Term No. 978. (Certificate.) The United States of America v. Boston & Maine Railroad. Term No. 979. Old Colony Trust Company et al., executors, vs. Commissioner of Internal Revenue. Filed May 9th, 1928. File Nos. 33430, 33431.

U. S. GOVERNMENT PRINTING OFFICE: 1928

In United States Circuit Court of Appeals for the First Circuit

Old Colony Trust Company et al., Executors, Petitioners for Review,

v.

Commissioner of Internal Revenue

Amended Statement of Facts—Filed March 15, 1929

Question of Law Certified by the United States Circuit Court of Appeals for the First Circuit to the Supreme Court of the United States May 2, 1928

March 14, 1929.

At the suggestion of counsel and in conformity with the order of the Supreme Court of the United States, dated February 18, 1929, the statement of facts with respect to Number 2218, contained in the certificate of this Court, dated May 2, 1928, is amended to read as follows:

This is a petition to review a decision of the United States Board of Tax Appeals. The petitioners are the executors of the will of William M. Wood, deceased. On June 27, 1925, the Commissioner of Internal Revenue notified Mr. Wood by registered mail of the determination of a deficiency in income tax against him for the years 1919 and 1920, under the Revenue Act of 1918. The amount of this deficiency was revised by the Commissioner's letter of August 18, 1925. On August 22, 1925, an appeal was taken to the Board of Tax Appeals. In response to an order to make petition more definite and certain, an amended petition was filed October 27, 1925. The hearing before the Board of Tax Appeals was held April 11, 1927, and the decision of the Board of Tax Appeals was rendered November 12, 1927. The Board of Tax Appeals approved the action of the Commissioner and found a deficiency in the federal income tax of Mr. Wood for the year 1919 of $708,781.93, and for the year 1920 of $350,837.14. The petition for review in this Court of the decision of the Board of Tax Appeals, pursuant to the Revenue Act of 1926 and Rule 38 of this Court, was perfected December 23, 1927.

William M. Wood was president of American Woolen Company during the years of 1918, 1919, and 1920. In 1918 he received as salary and commissions from the company $978,725, which he included in his Federal income tax return for 1918. In 1919 he received as salary and commissions from the company $548,132.87, which he included in his Federal income tax return for 1919.

August 3, 1916, the American Woolen Company duly adopted the following resolution, which was in effect in 1919 and 1920.

"Voted: That this company pay any and all income taxes, State and Federal, that may hereafter become due and payable upon the salaries of all the officers of the company, including the president, William M. Wood; the comptroller, Parry C. Wiggin; the auditor, George R. Lawton; and the following members of the staff, to wit: Frank H. Carpenter, Edwin L. Heath, Samuel R. Haines, and William M. Lasbury, to the end that said persons and officers shall receive their salaries or other compensation in full without deduction on account of income taxes, State or Federal, which taxes are to be paid out of the treasury of this corporation."

This resolution was amended on March 25, 1918, as follows:

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" 'The difference between what the total amount of his tax would be, including his income from all sources, and the amount of his tax when computed upon his income excluding such compensation or salaries paid by this company.' "

Pursuant to these resolutions the American Woolen Company paid to the collector of internal revenue Mr. Wood's Federal income and surtaxes due to salary and commissions paid him by the company as follows:

Taxes for 1918 paid in 1919	$681,169.88
Taxes for 1919 paid in 1920	351,179.27

The decision of the Board of Tax Appeals here sought to be reviewed was that the income taxes of $681,169.88 and $351,179.27 paid by the American Woolen Company for Mr. Wood were additional income to him for the years 1919 and 1920.

By the Court.

Arthur I. Charron, Clerk.

A true copy. Attest: Arthur I. Charron, Clerk. [Seal United States Circuit Court of Appeals, First Circuit.]

[File endorsement omitted.]

Office Supreme Court,
FILED
JAN 8 1929
CHARLES ELMORE CRO
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No. 129.

IN THE

Supreme Court of the United States.

OCTOBER TERM, 1928.

UNITED STATES OF AMERICA
v.
BOSTON & MAINE RAILROAD.

On Certificate From the United States Circuit Court of Appeals for the First Circuit.

BRIEF FOR THE BOSTON AND MAINE RAILROAD.

JAMES S. Y. IVINS,
Counsel for Boston & Maine Railroad.

Of Counsel:
THORNTON ALEXANDER,
KINGMAN BREWSTER,
E. S. KOCHERSPERGER,
O. R. FOLSOM-JONES,
JOSEPH D. BRADY.

January, 1929.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1928.

No. 129

UNITED STATES OF AMERICA.

v.

BOSTON & MAINE RAILROAD.

On Certificate From the United States Circuit Court of Appeals for the First Circuit.

BRIEF FOR THE BOSTON & MAINE RAILROAD.

OPINION BELOW.

The opinion of the District Court for the District of Massachusetts, rendered in favor of the taxpayer, is reported in 23 Fed. (2d) 343. For the convenience of the court this opinion is printed in full as Appendix B to this brief, at page 64.

JURISDICTION.

This case is here on certificate from the Circuit Court of Appeals for the First Circuit, filed May 9, 1928.

QUESTION PRESENTED.

In the words of the District Court:

"This case was selected from several other similar ones[1] to test the question whether the payment of the Federal income tax under a lease which provided for the payment of all taxes by the lessee subjects the lessor to a further tax on the sum of money so paid."

STATUTES INVOLVED.

The Revenue Act of 1917, section 1206, amended section 10 of the Revenue Act of 1916 to read:

> "Sec. 10. (a) That there shall be levied, assessed, collected, and paid annually upon the total net income received in the preceding calendar year from all sources by every corporation, * * * a tax of two per cent upon such income; * * *"

The Revenue Act of 1917 also made the following provisions:

> "Sec. 4. That in addition to the tax imposed by subdivision (a) of section ten of such Act of September eighth, nineteen hundred and sixteen, as amended by this Act, there shall be levied, assessed, collected, and paid a like tax of four per centum upon the income received in the calendar year nineteen hundred and seventeen and every calendar year thereafter, by every corporation, * * *"
>
> "Sec. 201. That in addition to the taxes under existing law and under this act there shall be levied, assessed, collected, and paid for each taxable year upon the income of every corporation, partnership, or individual, a tax (hereinafter in this title referred to as the tax) equal to the following percentages of the net income:
>
> "Twenty per centum of the amount of the net

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[1]The reason given by the Circuit Court of Appeals for certifying the question is that numerous cases are pending in which this question is involved.

income in excess of the deduction (determined as hereinafter provided) and not in excess of fifteen per centum of the invested capital for the taxable year;

"Twenty-five per centum of the amount of the net income in excess of fifteen per centum and not in excess of twenty per centum of such capital;

"Thirty-five per centum of the amount of the net income in excess of twenty per centum and not in excess of twenty-five per centum of such capital;

"Forty-five per centum of the amount of the net income in excess of twenty-five per centum and not in excess of thirty-three per centum of such capital; and

"Sixty per centum of the amount of the net income in excess of thirty-three per centum of such capital."

"Sec. 203. That for the purposes of this title the deduction shall be as follows, except as otherwise in this title provided—

"(a) In the case of a domestic corporation, the sum of (1) an amount equal to the same percentage of the invested capital for the taxable year which the average amount of the annual net income of the trade or business during the prewar period was of the invested capital for the prewar period (but not less than seven or more than nine per centum of the invested capital for the taxable year), and (2) $3,000; * * *"

"Sec. 12 (a)[2] In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

"First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a con-

[2]As continued from the Revenue Act of 1916.

dition to the continued use or possession of property to which the corporation has not taken title or is not taking title, or in which it has no equity * * *

"Fourth. Taxes paid within the year imposed by the authority of the United States (except income and excess profits taxes) * * *[3]"

STATEMENT OF FACTS.

The facts as certified by the Circuit Court of Appeals (R. 1, 2) are as follows (italics supplied):

"This action is brought by the Boston & Maine Railroad to recover income taxes for the year 1917, claimed to have been erroneously collected. In the District Court the plaintiff recovered a judgment for the full amount of its demand—$3,920.55 and interest.

"*June 30, 1900*, the Fitchburg Railroad Company leased all its railroad and property of every description to the Boston & Maine Railroad for the term of ninety-nine years. In the lease *the lessee covenanted to pay specified rentals*,[4] to maintain and replace the leased properties in manner indicated, to pay all operating expenses, *and* to pay '*all taxes* of every description, Federal, State, and municipal, *upon the lessor's* property, business, indebtedness, *income*, franchises, or capital stock, *or said rental*,' and to pay divers other charges. In 1918 an income tax return, under the provisions of the revenue acts of 1916 and 1917, was filed on behalf of the Fitchburg Railroad Company for the calendar year 1917, upon which taxes amounting to $61,422.06 were assessed. These taxes were paid to the Commissioner of Internal Revenue by the Boston & Maine Railroad pursuant to the

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[3]Words in parentheses new with Revenue Act of 1917.

[4]By paying directly to the stockholders of the lessor specified dividends on their stock—see opinion of District Court at p. 65, below.

term of the lease. The Fitchburg Railroad Company was consolidated with the Boston & Maine Railroad in 1919.

"In 1921 the Commissioner of Internal Revenue assessed an additional income tax against the Fitchburg Railroad Company of $3,920.55. In doing this he treated the payment of $61,422.06[4] made by the Boston & Maine Railroad to the Collector of Internal Revenue as additional taxable income to the Fitchburg Railroad Company to the extent of $65,342.61.[5] This additional tax of $3,920.55 was paid to the Collector of Internal Revenue by the Boston & Maine Railroad in July, 1921.

"The claim for refund of this additional tax was duly filed with the Commissioner of Internal Revenue, but was never formally acted upon, and more than six months having elapsed after it was filed, this action was brought for the recovery of the tax so paid."

THE ISSUE.

The Boston & Maine Railroad[6] contends that when it paid the 1917 income tax on the income of the Fitchburg Railroad Company, such payment of $61,422.06 did not constitute additional taxable income to the Fitchburg of $65,342.61 or any other amount for 1917 or any other year.

The Government contends that such payment did constitute additional income to the Fitchburg, but whether in the sum of $65,342.61 or $61,422.06 and whether for 1917 or 1918 is not clear—for the Gov-

[4]Note that taxes paid were treated as additional income not to the extent of the amount paid but *in excess thereof* by 6.383%.

[6]By reason of the consolidation mentioned in the statement of facts, the Boston & Maine now stands in the place of the Fitchburg (lessor).

ernment in filing a single brief in Nos. 129 and 130 seems to be attempting simultaneously to sustain the position taken by it in the District Court in No. 129 that the tax paid constituted additional taxable income *in excess* of the amount thereof and for the *same* year, and also to sustain the position of the Board of Tax Appeals in No. 130 that the tax paid constituted additional taxable income in *exactly* the amount of the tax paid but for the *next subsequent* year.

Summary of Argument.

The payment of a lessor's income tax, in accordance with the provisions of a lease made prior to the adoption of the Sixteenth Amendment to the Constitution, does not constitute additional taxable income to the lessor.

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VII. The Government Can Not Render its Theory Reasonable by Arbitrarily Departing from it after One Computation (p. 43).

VIII. The Practical View (p. 45).
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Edwards v. *Slocum*, 264 U. S. 61.
Elmer Candy Co. v. *Fauntleroy*, 24 Fed. (2d) 95.
Cliquot Club v. *U. S.* 13 Fed. (2d) 970.
Lash's Products Co. v. *U. S.*, 64 Ct. Cl. 252.
White Rock, etc., Co. v. *Edwards*, 23 Fed. (2d) 539.
Smith Grapejuice Co. v. *U. S.*, 63 Ct. Cl. 140.
Edwards v. *Slocum*, 264 U. S. 1.
Nichols v. *Coolidge*, 274 U. S. 531.

IX. Distinction Between Lawful Avoidance and Illegal Evasion of Taxes (p. 51).
Blackstone's Commentaries II, 339.
U. S. v. *Isham*, 17 Wall. 496.

X. Principles of Construction Applicable (p. 52).
Eisner v. *Macomber*, 252 U. S. 189.
Lynch v. *Hornby*, 247 U. S. 339.

Merchants Loan & Trust Co. v. *Smietanka*, 255 U. S. 509.
United States v. *Supplee-Biddle Co.*, 265 U. S. 189.
Edwards v. *Slocum*, 264 U. S. 61.
Gould v. *Gould*, 245 U. S. 151.
Lynch v. *Alworth-Stephens Co.*, 267 U. S. 364.

ARGUMENT.

I.

Introductory.

It should be noted that the facts in the two cases certified together are essentially different and that the certificate really contains two questions indicated by the disjunctive use of "or."

> "Does the payment by the lessee in No. 2235 [129 here] *or* by the employer in No. 2218 [130 here] of the income taxes, assessable against the lessor in the first case and the employee in the second, constitute additional taxable income to such lessor *or* to such employee." (Italics supplied.)

Because of the distinctions in the facts counsel for the taxpayers are filing separate briefs in the two cases. The principal differences of fact between the two cases are:

(1) The payment by the lessee in No. 129 was pursuant to a lease made in 1900, *long prior to the Sixteenth Amendment* and even to the Corporation Excise Tax Act of 1909, while the payment by the employer in No. 130 was made pursuant to a directors' resolution first adopted in 1916.

(2) The payment in No. 129 was made pursuant to a contract under which the lessee must pay *all* taxes assessed against the lessor—which must include not only the tax on the rental-income but any secondary tax on that tax (if it constitutes additional income) and any tertiary tax on that secondary tax (which must also be income if the first tax be held to be income) and so on *ad infinitum;* while the resolution in No. 130 might be construed not to be a contract but

a gratuity, or might be construed as an assumption by the employer of only the tax on the salary but not also of any tax on the tax.

(3) In No. 129 the lessee was a public service corporation, in No. 130 the employer was not.

It is the purpose of counsel for Boston & Maine Railroad to confine this brief to the situation arising under the facts in No. 129 and the similar cases referred to in the opinion of the District Court for which it was selected as a test case.

Prior to June 30, 1900, the Fitchburg was an operating railroad company. All the revenues from its operations belonged to it. It had to pay all its expenses, including taxes of all kinds, and the balance, if any, was its profit. If it had continued to operate until after the Federal Government began imposing income taxes, it could have treated those taxes as operating expenses for the purposes of making rates[7] and (even though it might not be permitted to deduct those taxes in the computation of net taxable income) it could raise its rates to assure itself a reasonable return upon its investment *after payment of income taxes*. It could have so fixed its rates that it could pay reasonable dividends to its stockholders regardless of taxes. As a simple method of assuring to its stockholders reasonable dividends (subject only to such taxes as might be imposed upon them as income of the stockholders rather than the corporation) it entered into the lease of June 30, 1900, by which the Boston & Maine took over its entire property, undertaking to fulfill all its obligations to the public in the maintenance and operation of the road, and agreed to pay *all operating costs, including all taxes* (on its income

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[7] *Galveston Elec. Co.* v. *Galveston*, 258 U. S. 388, 399.

as well as its property, franchises, et cetera), and *further* to pay fixed dividends directly to the Fitchburg's stockholders.[8]

The lease was so drawn that the dividends would be paid to the Fitchburg stockholders without diminution for any taxes that might be imposed on the property or income of the corporation. It left them assured of the reasonable dividends they might have expected *regardless of the imposition of Federal income taxes* had the Fitchburg continued to operate its road. For the assurance of such fixed dividends the stockholders forwent the possibility of higher dividends they might have expected had the Fitchburg continued to operate and to prosper.

From the point of view of the Boston & Maine,[9] it became obligated to pay *rental* in the form and to the extent of the dividends, and it also assumed, *as one of the operating expenses but not as rental*,[10] the payment of any taxes which although not then in being might by some future legislative enactment be imposed on the *income* of the lessor. Subsequently, various Federal courts held that dividends paid to stockholders of a lessor road by a lessee constituted taxable income to the lessor,[11] and the Boston & Maine accordingly (without litigating the question) paid to the Collector of Internal Revenue in 1918 a tax of $61,422.06—six per cent on the rental dividends paid to the Fitchburg stockholders in 1917. It paid six

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[8]Quarterly dividends of $1.25 per share on preferred and $.25 per share on common stock outstanding—see opinion of District Court at p. 65, below, or the lease set forth in full in the record before the Circuit Court of Appeals.

[9]And according to the phraseology of the lease.

[10]*Duffy* v. *Central R. R. of N. J.*, 268 U. S. 55.

[11]*Rensselaer & Saratoga R. R. Co.* v. *Irwin*, 249 Fed. 726, and similar cases discussed under point V, below.

per cent on only the amount of those dividends, *because those dividends represented all the net income the Fitchburg could possibly have*—it was entitled to receive nothing itself and its stockholders were entitled to nothing more (and to nothing less) than the dividends.

But then came the Treasury Department and, in the words of the District Court, "discovered a *new* manner of creating wealth" terminating "the age-long search for the Philosopher's Stone, which would turn into gold whatever it touched." It asserted that the *tax* paid on the dividends constituted *income* to the lessor corporation. Not only that, it asserted that the tax of *$61,422.06* constituted income *to the extent of $65,342.61*. As the District Court said "By merely laying the primary tax the Department thereby creates income, which is subject to a secondary tax; this in turn is further income, which is subject to a tertiary tax; and this in turn gives rise to a quarternary tax; and so on *ad infinitum*."

The District Court decided this case in favor of the taxpayer on the simple and elementary ground that the payment of the tax was not income to the Fitchburg Railroad Company, for the Fitchburg was not enriched thereby—it was no better off than if no income tax law had ever been enacted. The court relied on *Duffy v. Pitney*,[12] which arrived at the same conclusion in a case where an obligor under a "tax-free covenant bond" paid an obligee's income tax.

The reasoning in those opinions would seem to be a complete answer to all the contentions of the Government, but we feel that the court is entitled to a discussion of the various arguments urged on behalf of the Treasury Department's position and submit the following points.

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[12] 2 Fed. (2d) 230, cert. denied, 267 U. S. 595.

II.

Definition of Income.

In order to be taxable under the authority of the Sixteenth Amendment to the Constitution, and not be restricted to direct taxation apportionment in accordance with article I, section 2, paragraph 3, an item must be income within the definitions laid down by the courts. The leading definition is that enunciated in *Doyle* v. *Mitchell Bros. Co.*:[13]

> "In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets."

This definition has been adopted in practically every subsequent court decision involving the meaning of the word "income." It was enlarged on and explained by this court in *Eisner* v. *Macomber*,[14] as we shall show more fully below. The courts, in defining income, have held that the Sixteenth Amendment to the Constitution only permits the direct taxation without apportionment of items which are *in fact income*[15]—it is not sufficient that the item *resemble* income. In order to come within the requirement that it be in fact income, an item must be one which is "usually classed as income."[16]

The viewpoint of some economists that income might be defined as a series of satisfactions or a series of benefits is not commonly accepted or understood in the community, and when the taxing authorities have

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[13]247 U. S. 179.
[14]252 U. S. 189.
[15]*Towne* v. *Eisner*, 242 Fed. 704; aff'd 245 U. S. 418.
[16]*United States* v. *Supplee-Biddle Hardware Co.*, 265 U. S. 189, 195.

wandered from the practical to the theoretical in their search for taxable income, the courts have restricted them to those things falling within the commonly accepted meaning of the term "income." For example, when a taxpayer who had promised his sons a million dollars with which to start business, bought oil stocks for about $500,000, held them until they were worth about a million dollars, and gave them to his sons, who promptly sold them, the New York State Income Tax Bureau assessed an income tax upon the $500,000 alleged gain. It was argued that the taxpayer had made a gift equivalent to a million dollars, that he had the satisfaction of giving a million dollars, received credit for giving a million dollars, parted with a million dollars—that in order to part with it, he must have had it and must have realized it, even though the parting itself constituted the realization—and that therefore he should pay an income tax on the realized gain. But the court took the practical view that a gift partook rather of the nature of a loss than of a gain to the donor, and held that no taxable income resulted.[17]

Originally the Treasury Department, in dealing with gain upon the sale of assets acquired prior to the effective date of the income-tax law, measured income by the difference between the market value at that date (even though lower than cost) and the sale price. The courts held that, unless there was an *actual* gain —an excess of sale price over cost—no taxable income was realized, rejecting the proposition that income might be a purely theoretical thing represented by the difference between an unrealized value at a given date and a sale price.[18]

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[17] *People, ex rel. Wilson,* v. *Wendell,* 196 N. Y. App. Div. 596.

[18] *Brewster* v. *Walsh,* 255 U. S. 536.

In *Eisner* v. *Macomber*, *supra*, after quoting the definition of "income" from *Doyle* v. *Mitchell Bros. Co.*, this court added:[19]

> "Brief as it is, it indicates the characteristic and distinguishing attributes of income essential for a correct solution of the present controversy. The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. '*Derived—from—capital; the gain derived from capital*'; etc. Here we have essential matter: *Not* a gain *accruing* to capital; not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the principal, *severed from* the capital, however invested or employed, and *coming in*, being '*derived*'—that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal—*that* is income derived from property. Nothing else answers the description.
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> "The same fundamental conception is clearly set forth in the Sixteenth Amendment—'Incomes *from* whatever *source derived*'—the essential thought being expressed with a conciseness and lucidity entirely in harmony with the form and style of the Constitution." (Italics in original.)

Other decisions to the effect that the word "income" in the constitutional amendment is to be taken according to its commonly accepted meaning are *Lynch* v. *Hornby*,[20] where this court indicated that Congress was authorized to tax without apportionment—

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[19]252 U. S. 189, at 207.
[20]247 U. S. 339, 344.

> "everything that became income in the ordinary sense of the word"—

and *Merchants Loan & Trust Co.* v. *Smietanka*,[21] where it insisted upon applying—

> "the commonly understood meaning of the term, which must have been in the minds of the people when they adopted the Sixteenth Amendment."

Congress may, in its discretion, tax *less* than all the income of a taxpayer. It may allow him specific exemptions, or credits for taxes paid to other sovereigns. It may allow the deduction of an inheritance tax, which does not go to reduce his income, but only to reduce the bequest (specifically excluded from his gross income) which, but for the tax, he would receive. But Congress may not directly tax (except by apportionment) *more* than all the income of a taxpayer—in the commonly accepted, common-sense meaning of the term. And the enactments of Congress will not be construed to have intended to levy an unconstitutional tax.

III.

A Financial Benefit Is Not Necessarily Income.

The principal argument urged below on behalf of the Government in this and similar cases is that payment by the lessee of income taxes asserted against the lessor, relieving the lessor of the necessity of making a similar payment itself, constitutes an advantage or benefit to the lessor which can be reckoned in dollars and cents, and that such an advantage or benefit must therefore be income. Of course, not all financial

[21] 255 U. S. 509, 519.

benefits are regarded as income—alimony,[22] damages for defamation,[23] or for physical injury to the person[24] are not regarded as taxable income to the recipients.

As Judge Lowell pointed out in the opinion below, the lessor is not enriched through the payment of its tax by the lessee. The contract was made at a time when there were no income taxes. The lessor contracted that its stockholders should receive certain dividends *net*. The subsequent imposition of the income tax made it necessary for the lessee to pay more than before—the additional payment being to the Government, and not to the lessor. But the lessor receives no more than if there were no income tax. It does not receive any additional income, but is merely protected against a reduction of the income which it does receive. The only advantage or benefit it receives is by contrast with a company which pays its own income tax.

But the fact that A may have such an advantage by contrast with B does not constitute income to A, unless he actually *receives* something which is derived from capital or labor, severed therefrom, and drawn by him for his separate use, as indicated in *Eisner* v. *Macomber*.

This is readily demonstrable by many examples: Suppose A is a judge of a state court, having a salary of $10,000, and B is counsel for a corporation, earning a similar salary. Suppose also that each has $20,000 income from investments. The income tax upon A might be as much as $1200[25] less than that on B, by

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[22] *Gould* v. *Gould*, 245 U. S. 151.

[23] Solicitor's Opinion 132, C. B. I–1, p. 92.

[24] Treasury Decision 2747.

[25] At 1918 rates.

reason of the exempt status of his salary as judge.[16] A, although receiving the same amount of money as B during the year, will have to pay $1200 less income tax. But no one would regard this $1200 as taxable income to A.

If it be suggested that the foregoing is not a fair example because the judge's exempt salary could not be reached indirectly even to the extent of $1200 if not taxable directly, it is easy to find examples not involving constitutional or statutory exemptions. Suppose A and B have equal incomes and exemptions, and each maintains an automobile for his pleasure. A carries casualty insurance, and B does not. Each has an accident resulting in damages to another person of $5000. The insurance company settles with A's victim, but B has to pay his own. In computing his tax B can not deduct from his income the damages he pays.[17] So, at the end of the year, A will be $5000 better off than B, due to his foresight in protecting himself against a reduction of his income by reason of something which might transpire during the taxable year. But no one would suggest that the payment by the insurance company to the person injured by A's car constitutes income to A. That situation is exactly parallel to that of the railroads in the case at bar. The reasons A is better off than B are that he has had foresight to contract in such manner as to protect himself against possible reduction of income, and that the tax law does not permit B to deduct his particular type of loss from his income in computing taxes. Similarly, the lessor railroad contracted, before any federal income tax was contemplated, against any reduction of

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[16] *Collector* v. *Day*, 11 Wall. 113.

[17] *Peyton* v. *Commissioner*, 10 B. T. A. 1129.

its income by such a tax should it ever be imposed; and the income-tax laws[28] prohibit a taxpayer from deducting its income taxes from its income in computing taxes.

Another example of financial benefit readily measurable in dollars and cents, but not taxable as income, is the use and occupation by a taxpayer of a dwelling-house which he owns. Suppose A and B each inherit $25,000, and that they have similar incomes from other sources. A invests his $25,000 in a dwelling, which he occupies. B invests his $25,000 in securities yielding $1500 a year, and pays the $1500 for rent of a dwelling. Under the statute, A's taxable income will be $1500 less than B's, for the financial advantage of owning his own home is not regarded as income, even though its rental value is readily measurable in money. So A will pay, say $150, less tax than B. But it would be absurd to suggest that this advantage of $150 should be treated as income to the extent of $150 and added to A's taxable income.

In *Bowers* v. *Kerbaugh Empire Co.*,[29] a taxpayer, prior to the World War, borrowed from a German bank certain moneys which it received in New York in dollars at then exchange rates (the mark being worth approximately 25 cents) and agreed to repay in marks, or their equivalent in dollars, at cable exchange rates. In 1921 when the mark had fallen to a value of about 2½ cents, the taxpayer paid back the loan in marks, which only cost it a small fraction of the dollars it had originally received. Here was a financial benefit or advantage obviously measurable in dollars and cents, but this court held it not to be income. Similarly, the

[28]Beginning with that of 1917.

[29]271 U. S. 270.

Board of Tax Appeals has held in several cases that where a corporation borrows money, issuing bonds therefor, and subsequently buys in the bonds before maturity, at a discount, it has not derived taxable income, though the financial advantage is indisputable and measurable in dollars and cents.[30]

Another case somewhat parallel to the one at bar is *Bowers* v. *New York Trust Co.*,[31] where a partnership, subject to excess-profits taxes, reduced its taxable income by the process of arranging that commissions on some of its contracts should not be paid to it, although it should continue to perform the work for which such commissions were payable. One of the partners received the benefit indirectly. It was held that the fact that one of the partners was in effect paid for work done by the partnership did not render the arrangement equivalent to income to the partnership (which was taxable as an entity). The court ruled against the Treasury Department's contention that the partnership received any taxable income in this indirect manner.

One of the commonest financial benefits measurable in dollars and cents, but not consisting of the actual receipt of money or property, is the benefit derived by a bankrupt when he is discharged. The liability side of his balance sheet is wiped out. He is relieved of the obligation of paying debts, but the Treasury Department has never strained construction so as to

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[30] *Appeal of Independent Brewing Co. of Pittsburgh*, 4 B. T. A. 870; *Appeal of New Orleans, Texas & Mexico Railway Co.*, 6 B. T. A. 436; *National Sugar Mfg. Co.* v. *Commissioner*, 7 B. T. A. 577; *Indianapolis Street Railway* v. *Commissioner*, 7 B. T. A. 397; *Meyer Jewelry Co.*, 3 B. T. A. 1319; *Houston Belt & Terminal Railway* v. *Commissioner*, 6 B. T. A. 1364.

[31] 9 Fed. (2d) 548.

assess income taxes against the financial benefit so derived.

The Government has never contended that the running of the statute of limitations against the collection of tax constitutes income in the year the statutory period expires. Certainly a taxpayer enjoys a *benefit* from the running of the statute. The liability is extinguished, but the taxpayer derives no gain from capital or labor in the year indicated. A benefit by statute is, we submit, no different from a benefit by contract. Each creates a legal right, recognized and enforcible, a benefit or advantage, but not a taxable gain.

The suggestion made on behalf of the Government that the payment by the Boston & Maine of the Fitchburg's taxes as part of the *consideration* under a contract renders it "income," is similar to the argument made on behalf of the Government and rejected by this court in *Edwards* v. *Cuba Railroad*,[32] a decision applied by the Board of Tax Appeals in *Appeal of Liberty Light & Power Co.*,[33] and *Appeal of Great Northern Railway Co.*[34] In these cases large financial benefits resulted to the taxpayers as consideration for services to be rendered, but the benefits were held not to constitute income.

It has been suggested at times, on behalf of the Government, that when the lessee pays taxes for the lessor, the lessor should treat such payment on its books as, first, a receipt by it of rent, and, second, a payment of taxes, the receipt going to increase gross income, but the taxes, under the statutory restriction, not going

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[32] 268 U. S. 628.
[33] 4 B. T. A. 155.
[34] 8 B. T. A. 255.

to diminish it in the computation of net income. This argument might be paralleled in the following example: Suppose that in 1915 (when losses by theft, not connected with business, were not deductible from gross income) a taxpayer was robbed of his pocketbook containing $1000. In his accounts he should enter the loss of $1000, but could not take credit therefor in his income-tax return. If shortly after the robbery his money was recovered by the police and returned to him, he should offset the loss on his books by the $1000 recovered. According to the Government's argument, this $1000 so recovered would be taxable income.

IV.

Taxes Paid by the Lessee Are Not "Rental" to the Lessor.

It is the Government's position that the payment of the lessor's income tax by the lessee was rental received by the lessor,[35] and in the court below, and in other similar cases, counsel for the Government have taken the position that the payments by the lessee constitute rental to the lessor or income in the nature of rent.

This court, in *Duffy* v. *The Central Railroad Company of New Jersey*,[36] states as follows:

> "The term 'rentals,' since there is nothing to indicate the contrary, must be taken in its usual and ordinary sense, that is, as implying a fixed sum, property amounting to a fixed sum, to be paid at stated terms for the use of property—and in that sense it does not include payments, uncertain both

[35] See computation, record below, p. 27.

[36] 268 U. S. 55.

> as to amount and time, made for the cost of improvements, *or even for taxes.*" (Italics supplied.)

The agreement by the lessee to pay the lessor's taxes can not be rental under the statement of this court, as it does not represent a *fixed sum* at *stated terms*, certain both as to amount and time, for the use of property. The advantage possessed by the lessor, in having the lessee pay its federal-income taxes, does not constitute rental received by it.[37]

Even if "in the nature of rent," this payment is not *income* to the taxpayer. Resemblances are not sufficient to support taxes. In *Towne* v. *Eisner*[38] the lower court very properly held that—

> "It is manifest that the stock dividend in question can not be reached by the Income Tax Act, and could not, even though Congress expressly declared it to be taxable as income, unless *it is in fact income.*"

An examination of the lease will show that the only rental provided for was the dividends payable to the stockholders, for which they were afforded the right of personal action against the lessee in the event of default in payment. Necessarily, when the rental was made payable direct to the lessor's stockholders the lessor would be without property or funds with which to meet any obligations, so in taking over the lessor's entire property and the right to receive the entire income therefrom, the lessee undertook to assume all possible liabilities of the lessor during the 99-year term.

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[37]See also *Guild* v. *Sampson*, 232 Mass. 509.

[38]242 Fed. 704; aff'd 245 U. S. 418.

The lessor thereby went out of business for the term of the lease.[39]

The Government attempts to argue the case on the assumption that the situation is the same as if the lessor had received all of the operating income and deducted all expenses and charges, excepting only the Federal income taxes. Such an argument, in effect, disregards the fact that this case involves a *lease* and not an agency.

V.

The Decisions upon the Questions Involved.

As far as we have been able to discover, there have been only six judicial decisions directly upon the question of the payment of one's tax by another and the treatment of such payment as additional income to the former. These cases are—

Duffy v. *Pitney*, 2 Fed. (2d) 230; cert. denied 267 U. S. 595, overruling *Massey* v. *Ledcrer*, 277 Fed. 123.

Appeal of Mary Clark Kling, 1 B. T. A. 1048, acquiesced in by the Treasury Department, C. B. IV-2, p. 3.

Appeal of Providence & Worcester Railroad, 5 B. T. A. 1186.[40]

Horst v. *United States*, 64 Ct. Cl. 449.

Boston & Maine Railroad v. *United States*, 23 Fed. (2d) 343 (this case below).

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[39] *McCoach* v. *Minehill & Schuylkill Haven R. R. Co.*, 228 U. S. 295.

[40] The *Old Colony Trust Company* case (No. 130 here) was decided by the Board by a mere reference to the *Providence & Worcester* case.

In view of the refusal of this court to grant certiorari in *Duffy* v. *Pitney*, and the acquiescence by the Treasury Department in the court's conclusion, we may ignore *Massey* v. *Lederer*, which was directly overruled in the *Duffy* case.

In the *Duffy* case, a corporation had issued bonds containing a provision that it would pay any taxes assessed against the bondholders because of ownership of the bonds. Section 221 (b) of the Revenue Act of 1918 provided:

> "In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods, and whether payable to a nonresident alien individually or to an individual citizen or resident of the United States or to a partnership: * * *"

Under this provision the corporation *withheld* from the interest payable to a bondholder (the taxpayer) 2 per cent, and paid it to the Government. The bondholder was credited in the Government's books with this payment. But, because of the covenant, the corporation had to make good the 2 per cent to the bondholder, and paid it the entire 100 per cent of interest called for by the bond. The Government took the position that the payment by the corporation

of the 2 per cent to the Government constituted additional income to the bondholder, and assessed an additional income tax thereon. The Circuit Court of Appeals held otherwise, saying:

> "applying the customary canons of construction to this tax legislation [citations], we do not believe in such case that the sum withheld at the source is income. It does not fall within any accepted definition of the term [citation]. It is not a 'gain' or 'profit' derived from any of the sources named in the statute (Section 213), nor (whatever it is) has it ever been 'received' by the taxable. It is not property, nor is it a right to property for, not being payable to the obligee, he can not recover it in an action at law against the obligor. *In its effect upon the obligee it is at most an intangible but very real advantage for which he has contracted and as a result of which a part of his taxes is paid by another.* In thus contracting for the payment of a part of his tax by another the taxable in this case did only what Congress expressly permitted him to do. Therefore his conduct was lawful and was in no sense an evasion of the payment of taxes or an obstruction to the collection of taxes, as in some cases relied upon by the defendants [citations]. We are of opinion, therefore, that the sum withheld at the source in obedience to the statute is a tax. The best authority for this is the statute itself, and the statute calls it a 'tax.' Being a tax, *we can not find that the Revenue Act* requires that it be included in a return as 'income' and that the act *intends thus to impose a tax upon income and also a tax upon a tax.*
>
> "In holding that 'a tax equal to 2 per centum of the interest upon such bonds,' withheld at the source [quoting Section 221 (b) of the Act of 1918], is not 'income' and, therefore, should not be included in a tax return of the bondholder, it would seem that the case is ended; but the defendants

urge that, if a tax, it is nevertheless a tax upon the holder of the bond and if a part of it is paid by another the bondholder receives his interest in full (100 per cent) and 2 per cent more,—in effect 102 per cent,—and therefore, he should be taxed upon the total percentage. The plaintiff, on the other hand, maintains that the tax is upon the obligor corporation. In this regard it is certain that the act imposes upon the corporation the duty of paying the tax to the extent of 2 per centum of the interest. With this duty upon the corporation, the *taxable obligee* is expressly allowed to deduct this tax in his return, but the corporation obligor is not allowed to deduct it in ascertaining its own net income (Section 234 of the Act of 1918)." (Italics supplied.)

The Treasury Department has acquiesced in this decision and amended its regulations to conform.[41] That it is controlling, where applicable, is admitted by the Government. And it can not be distinguished from the question now before this court. Everything in the quotation above can be applied to taxes paid for a lessor by a lessee.

Counsel for the Government try to distinguish the two cases on the ground that, with respect to tax-free covenant bond interest, the statute provided for the payment of 2 per cent by the corporation, while in our case the obligation arose solely from contract. But an examination of the statute referred to shows that our case is stronger, in logic, for the taxpayer. The statute provided for *withholding* by the corporation of 2 per cent of interest due the taxpayer. This gave some basis to the Government's argument that the money paid by the corporation to the Government was the taxpayer's money, part of his interest disbursed

[41]Treasury Decision 3685.

for his account; that in addition he got the balance, 98 per cent of his interest, and a further sum (equivalent to 2 per cent) paid under the covenant. The court looked through this theorizing to the practical proposition that the payment of a tax by a corporation to the Government did not constitute *receipt* of anything *coming in* to the bondholder. In our case the Government can not make even that argument, for there was no withholding—no basis for saying that the money paid by the lessee to the Government was part of the income of the lessor withheld in accordance with statute, or that part of the rental paid to the lessor was not rental, but a sum equivalent to tax withheld, paid by reason of a covenant.

The arguments, other than the one just mentioned, of the Government in *Duffy* v. *Pitney*, were the same as those urged in our case. We believe this court will treat them as the Circuit Court of Appeals for the Third Circuit treated them.

It should be noted that the obligation upon corporate obligors under tax-free-covenant bonds arose by private contract, as does the obligation of the lessee railroad. Congress did not impose that obligation; it merely recognized it and legislated to preserve the right of the bondholder. In our case the lessor needed no such legislation.

The practice of lessee railroads agreeing to pay all taxes assessed against lessors has long been common and well known in the business and legislative world. If Congress had intended to treat these contracts as resulting in additional income to lessors and additional deductions to lessees, it is unbelievable that it would have failed specifically so to indicate by the time it went into such careful detail as it did in the Revenue Acts of 1917 and all subsequent revenue acts.

In the *Appeal of Mary Clark Kling*[42] the Board of Tax Appeals followed *Duffy* v. *Pitney*, and its decision was acquiesced in by the Commissioner of Internal Revenue.[43]

In *Horst* v. *United States*[44] the Court of Claims followed the *Duffy* opinion in a decision rendered January 16, 1928, saying, *inter alia:*

> "We are of the opinion that this tax paid by the obligor corporation was not 'gain' or 'profit' from sources named in the statute and was not 'received' by the taxpayer. *Eisner* v. *Macomber*, 252 U. S. 189, 207. It is not property and the holder of the bond could not recover it in an action at law against the obligor. Nor is it payable to the holder. See *Duffy* v. *Pitney*, 2 Fed. (2d) 230, where the question is very fully and satisfactorily discussed."

In Judge Lowell's opinion in the case at bar, he sustains the taxpayer's position on the authority of *Duffy* v. *Pitney*, and on the broad ground that the "Fitchburg Railroad gets no gain or profit. It is not made richer by the tax so paid. Its financial situation is the same as when no income tax is laid, and continues the same however high the rate of such taxation may become." This reasoning might be elaborated or paraphrased in many ways. In its essence it is but a logical conclusion that one must be enriched in order to be held to have taxable income and one is not enriched merely because he has had the foresight to contract against impoverishment. If a reduction of losses does not constitute income, as this court held in *Bowers* v.

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[42] 1 B. T. A. 1048.
[43] C. B. IV–2, p. 3.
[44] 64 Ct. Cl. 449.

Kerbaugh Empire Co.,[45] certainly the prevention of loss or other reduction of income can not constitute income.

The only case looking the other way is the *Appeal of Providence & Worcester Railroad Company*,[46] where the Board of Tax Appeals, in an opinion by Mr. Phillips, upheld the Government's contention and attempted to distinguish *Duffy* v. *Pitney*. With respect to the general conclusions of the Board we urge everything that we say elsewhere in this brief on behalf of our position. With respect to the attempt to distinguish *Duffy* v. *Pitney* we call attention to the fact that the Board placed the distinction principally on the ground that "the tax paid by the obligor was a tax upon it and not one imposed on the obligee, even though the same law reduced the amount of tax due from the obligee." This is obviously an error. The tax was not imposed upon the obligor, as the District Court for the Southern District of New York has shown in a well reasoned opinion in *Union Pacific Co.* v. *Bowers*.[47] Furthermore it could not constitutionally be imposed upon the obligor by reference to the obligee's income. The tax, based on income of the obligee, was collected from the obligee by a process of sequestration —a process similar to that provided for collection of taxes against non-resident aliens and non-resident foreign corporations.[48] The tax collected from the obligor under tax-free-covenant bonds, exactly like the tax collected from an obligor of an alien or a foreign corporation, was levied and assessed with

[45]271 U. S. 170.

[46]5 B. T. A. 1186. (Followed without detailed reasoning in several subsequent decisions of the Board, including the case which is now No. 130 here.)

[47]28 Fed. (2d) 370.

[48]Cf. Revenue Act of 1918, §§ 221 (a) and 237.

respect to income of the latter, was *withheld from that income* by the former, who was designated a "withholding agent."[49] The Circuit Court of Appeals carefully avoided committing itself to the argument of the plaintiff that the tax was upon the obligor, indicating that while the act imposed upon the obligor the duty of paying the tax, "the *taxable obligee* is expressly allowed to deduct[50] this tax in his return." Congress did not and could not impose a tax on one person measured by the income of another. What it did was to attach the credits of the taxpayer in the hands of the obligor and collect the tax by the withholding process. If the obligee, after having had a tax, stated by the statute to be withheld from his income, paid to the Government for him by the obligor, then received from the obligor the amount of that tax, and such receipt did not constitute additional income to the obligee, certainly the payment of a tax for the lessor by a lessee can not constitute additional income to the lessor.

The Board relied largely upon the decisions in *Rensselaer & Saratoga R. R. Co.* v. *Irwin*, 249 Fed. 726, and *Houston Belt & Terminal Ry. Co.* v. *United States*, 250 Fed. 1, which are two of a group of decisions in cases which are the main reliance of the Government in its brief here. In them lessee companies agreed (as in the case at bar) to pay, for the use of the property of lessor companies, dividends on the lessors' stock, directly to stockholders. The payments so made to the lessors' stockholders were treated as taxable income to the lessors. The Board states that it is unable to

[49] "The term 'withholding agent' means any person required to deduct and withhold any tax under the provisions of § 221 or § 237." Revenue Act of 1918, § 200.

[50] A deduction from taxes otherwise payable, not a deduction from income.

see any distinction in principle between those cases and the case where a lessor's income tax is paid. The distinction may readily be found, however, in the fact that in those cases the payments treated as income were *rent*, in this case they are *taxes;* and the decisions in those cases do not involve the necessity of considering the incidence of the tax in the levying of the tax, while the Government's position in this case does necessitate such process in spite of the denunciation thereof by this court in *Edwards* v. *Slocum*.[51] These same cases were relied on by the Government in *Duffy* v. *Pitney* and in the *Appeal of Mary Clark Kling*, and they did not seem to the Circuit Court of Appeals or the Board to be controlling or even parallel.

Since these cases seem to constitute the main reliance of the Government, we feel that they should be carefully examined. In the one decided in the First Circuit, *West End St. Railway Co.* v. *Malley*,[52] the lease "expressly refers to and treats these payments to stockholders as part of the agreed rent for the property," and it was upon this ground that the majority of the court treated such payments as income.

Similarly, in *Blalock* v. *Ga. &c. Co.*,[53] the lease provided that the lessee "will pay to the said shareholders respectively, as and for rent hereunder * * * quarterly sums or dividends." The basis of the court's decision seems to have been practically a disregard of the corporate entity, for it said (p. 389):

> "Rents accruing and paid for the use of partnership property are not made any the less partnership income by being made payable to the several persons in proportion to their respective shares

[51] 264 U. S. 61, 63.

[52] 246 Fed. 625, December 10, 1917; cert. denied 246 U. S. 671.

[53] 246 Fed. 387, 5th Circuit, November 7, 1917.

> or interest in the firm at the time the payment is made. There is no such difference between a partnership and a corporation as to require a different conclusion, and the only difference is that the recipients of the payment are the stockholders of a corporation instead of the members of a partnership."

In *Anderson* v. *Morris & Essex R. R. Co.*[54] the court held that the lessor railroad was not taxable under the 1909 law. It said, *obiter:*

> "Without going into the matter at length, it suffices to say that the fact that the lessee paid the *rent*, not to the corporate entity but to the stockholders and bondholders, can not prevent the act from applying to the money so paid if the other conditions of the act make its terms applicable. The fiction referred to can not be permitted to accomplish a fraud upon the statute and an evasion of its obligations." (Italics supplied.)

It should be noted that the court considered the payments as *rent*, and they might well come within the definition of this court quoted above[55] from *Duffy* v. *Central R. R. of New Jersey.*

In *Rensselaer, &c. R. R. Co.* v. *Irwin*[56] the majority of the court based its opinion largely upon the obiter language above quoted from *Anderson* v. *Morris & Essex R. R. Co.*, but it appears that the lessee had agreed to pay *rent* by paying interest on specified bonds and stated dividends on the lessor's stock. The court said:

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[54]216 Fed. 83, 2d Circuit, July 9, 1914.

[55]P. 24.

[56]249 Fed. 726, 2d Circuit, January 16, 1918; cert. denied 246 U. S. 671.

> "The application of the rent under the lease is a mere labor saving device, the effect being exactly the same as if it be paid to the lessor, and by it paid out, as far as necessary, to bondholders for interest, and the surplus and dividends to its stockholders. The description of the fixed sum to be paid by the lessee of 8 per cent to the lessor's stockholders as a dividend, shows that the payment is made as agent of the lessor."

The decision was subsequently explained by that court as follows:

> "Those cases regard a distribution to the constituent members [shareholders] of the corporate entity as equivalent to a payment to the entity itself and a distribution by it."[17]

In other words, in those cases the corporate fiction was disregarded and a payment to the stockholders treated as a payment to the corporation, the stockholders and the corporation being regarded as the same. Of course, there is no basis for regarding the United States and the lessor railroad in this case as the same.

In *Houston Belt & Terminal Railway Co.* v. *United States*[18] the lessee companies paid interest and sinking funds on the lessor's indebtedness directly to the creditors, *as rent*. The court said:

> "We think it clear that the payment of such sums, in pursuance of their covenant, was but a payment of rent by the tenant companies to the terminal company for the use of the premises occupied by them"—

and the *Blalock* case was cited.

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[17] *Bowers* v. *New York Trust Co.*, 9 Fed. (2d) 548.

[18] 250 Fed. 1, 5th Circuit, April 10, 1918.

It should be noticed that every one of these cases was decided before this court explained the definition of income in *Eisner* v. *Macomber*. Subsequent cases on the same question have not contained any reasoning, but have merely applied the prior rulings, *e. g.*, *Northern R. R. Co. of New Jersey* v. *Lowe*,[59] *United States* v. *Western Union Tel. Co.*[60] We respectfully suggest that the court might find it interesting to re-read the dissenting opinions of Judge Aldrich in the *West End St. Railway Co.* case, and of Judge Hough in the *Rensselaer & Saratoga* case, in the light of this court's exposition of the nature of *income*.

This group of cases was relied on by the Government in *Massey* v. *Lederer*,[61] one of the tax-free-covenant bond cases, and the District Court accepted them as sustaining its judgment in favor of the Government. But the Circuit Court of Appeals for the Third Circuit overruled the *Massey* case in *Duffy* v. *Pitney*, as we have shown above, by deciding the same question the other way. Their opinion does not state that they considered the *Massey* case, but the fact that the dissenting Judge (Thompson) was the author of the *Massey* opinion leaves no question in our minds that it was carefully examined. The court specifically mentions the group of stockholder cases relied on by the Government, but does not regard them as in point.[62]

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[59]250 Fed. 856.

[60]19 Fed. (2d) 157.

[61]277 Fed. 123 (D. C. E. D. Pa.), December 30, 1921.

[62]If a taxpayer creates a trust for the benefit of others, conveying specified property to a trustee for a term of years, to manage the same, pay all expenses and taxes, and distribute the income periodically among the *cestuis que trustent*, that income is taxable under the Revenue Act of 1916 (Sec. 2 b) and subsequent Revenue Acts (Sec. 219) to the beneficiaries receiving the same (or to the trustee where the

Where the payment of interest on a lessor's bond is concerned, the question of whether it constitutes income or not is now academic because the interest would be deductible to the lessor and this deduction would off-set the income. With respect to the payment of dividends by a lessee to its lessor stockholders, it seems to us that the only ground upon which the cases discussed above can be sustained is that the nature of a dividend implies corporate income in the process of distribution, and there is no similarity between that and payment of taxes on that very income.

The exaction by the lessor of a payment of a specified sum regularly at specified periods, whether to itself or to its stockholders, was essentially rent—an exaction for the use of property—and was so recognized in the leases and by the courts. But the provision that the lessee should maintain the property in its then present condition, and the payments made by the lessee toward such maintenance, were not compensation to the lessor for the use of property, but merely protection to the lessor against loss in value of its capital. The payments made by the lessee, protecting the lessor's capital,

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income is held for future distribution) and not to the grantor. There would seem to be no sound reason why a corporation could not create such a trust for the benefit of its stockholders, and cease, for the period of the trust, to have any income of its own. The moneys received by the beneficiaries would be income from trust funds, taxable as such, rather than dividends. The courts which decided the cases under discussion might well have held that the leases constituted trusts for the benefit of the stockholders of the lessor companies, instead of ignoring the differences between corporation and stockholders (which this court refused to do in *Eisner* v. *Macomber*, repudiating *Collector* v. *Hubbard*, 12 Wall. 1) and treating payments to the latter as to the former.

did not constitute income to the lessor. The provision with respect to taxes was a similar provision, protecting the lessor's income. At the time the lease in the case at bar was made, the possibility of a federal income tax was extremely remote. Yet, in its foresight, the lessor protected its income against reduction by that possibility. It did not provide for definite sums of money to be paid at specified periods, any more than in the case of the requirement for maintenance of the property. It merely required that its income be protected from diminution just as its principal was to be protected from depreciation.

The Government urges that if the lessee in No. 129 had paid to the lessor the amount which the latter was called upon to pay as taxes the money would be income in the hands of the lessor as a gain derived from the use of its property. This, we submit, is not so. The lessee was not obligated to pay the taxes to the lessor. Under such circumstances, if the lessee had paid the amount of the lessor's tax to the lessor, the lessor would have received it, not for its own use and enjoyment, as in the case of rent, but as a trustee for the sole purpose of paying it to the United States.

The Government's brief (p. 15) makes a point that the principle contended for on behalf of the Government has received judicial approval, and cites *In re Levalley's Estate*[63] and *In re Irwin's Estate*,[64] in each of which the will provided for the payment of legacy taxes out of the residue, and the residuary legatee was a charitable corporation. The state courts, in computing the taxable legacies, added to them the taxes paid out of the residue. These decisions are in direct con-

[63]191 Wis. 356, 210 N. W. 941.
[64]196 Cal. 366, 237 Pac. 1074.

flict with that of this court in *Edwards* v. *Slocum*.[55]

In that case this court said (p. 62):

> "The Government required the payment of an additional sum reached by deducting from the exempted estate the amount of the tax to be paid, or in other words, adding the amount of the tax to the taxable estate."

and (p. 63):

> "[the statute] thus manifestly assumes that the net estate will be ascertained before the tax is computed."

In the *Slocum* case the tax on the taxable "net estate" was paid out of the exempt residue, and did not reduce the legacies received by the legatees entitled to the "net estate," and the Government attempted to add the tax to the "net estate." In our case the tax on the taxable "net income" was paid by the lessee and did not reduce the rent received by the lessor entitled to the "net income."

In the estate tax case the "net estate" was computable by reducing the gross estate by all logical charges going to reduce what would be eventually enjoyed by the legatees, *but not by the estate tax*. In our case the "net income" is computed by reducing gross income by all logical charges going to reduce what the lessor would eventually enjoy, *but not by the income tax*.

But in neither case does the payment of the tax by another *increase* the net amount upon which the tax is computable.

Substituting "income" for "estate," we insist, in the language of this court quoted above, that *the statute "manifestly assumes that the net income will be ascertained before the tax is computed."*

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[55]264 U. S. 61.

VI.

The Government's Theory, Carried to Its Logical Conclusion, Results in Absurdity.

Five different methods of applying the Government's theory that the payment of a lessor's taxes by its lessee constitutes income to the lessor have been urged or applied by the Government in different proceedings. An exposition and classification of these five methods, is annexed hereto as Appendix A.[66]

If a tax paid by a lessee for a lessor is additional income to the lessor, and an additional tax must be assessed upon it, that additional tax is equally payable by the lessee. It is the same kind of a tax (if it is not an income tax it can not be asserted under an income-tax law—nor could Congress impose it without apportionment), and subject to the same provisions of the lease. When paid by the lessee the additional tax will be additional income to the lessor just as much as the original tax. So, logically, it is necessary to complete the pyramid. That is what the Government did in this case of the Fitchburg Railroad Company. It adopted a short cut in the computation, explained in Appendix A, at pages 54, 55.

The Government's brief here ignores the fact that it was agreed in the District Court[67] that this is a test case for others, and that the reason given by the Circuit Court of Appeals for certifying the question is that numerous cases are pending in which this question is involved (R. 3). The Government urges that it is very simple to divide the rental income by .94 and take 6 per cent of the quotient. But since this is a

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[66]P. 53.

[67]See opinion of District Court at p. 64, below.

test case we must consider the effect of any decision on cases where there is not merely a simple 6 per cent tax, but excess profits taxes (and even war profits taxes) involving many elements beside income and running as high as 80 per cent.

The result is monstrous. A by no means impossible example will show the extreme to which the theory carries us. Suppose that, for the year 1918, the income from rents of the A corporation was $1,000,000, and that its invested capital was such that its tax for 1918 was $500,000, part of which was computed at the rate of 80 per cent on income.[68] Any additional income attributed to A would result in further taxes at 80 per cent. Suppose, further, that the B corporation was under obligation to pay all taxes of the A corporation. On the theory that the payment of the $500,000 tax by the B corporation constituted $500,000 further income to the A corporation, an additional tax of $400,000 would be assessable thereon. If paid by the B corporation, this $400,000 would be just as surely income to the A corporation as was the $500,000, and a tax should be assessed on it of $320,000. Again, the payment by B of the $320,000 would be income to A, resulting in a tax of $256,000. This process would have to be repeated until the last additional tax amounted to less than half a cent and could be ignored under the law. It would require 82 separate computations of tax, and the total tax which the B corporation would have to pay would be $2,499,999.86—only 14 cents short of 250 per cent on the actual income of the A corporation. We speak of the process as pyramiding, but the column of figures which we must add together to compute the tax looks more like an obelisk than a

[68] The 80 per cent rate appeared in the 1918 law.

pyramid. Of course, an algebraic computation might be substituted for the 82 arithmetical ones it was necessary to make in the hypothetical case, but with invested capital involved as a factor it would be far from simple,[69] and "algebraic formulae are not lightly to be imputed to legislators"[70]—nor, we might suggest, are computations involving pyramiding.

By the same token, if the pyramiding were done on the theory that the payment of the 1917 tax in 1918 constituted income for 1918 rather than for 1917,[71] the result would be equally absurd. If the tax rates provided in the 1918 law were continued, it would take eighty-three years to pay off the tax in our hypothetical case, and the aggregate would be 250 per cent of the actual income.

VII.

The Government Can Not Render Its Theory Reasonable by Arbitrarily Departing from It after One Computation.

If Congress enacted a tax at a rate so high that it was obvious that it was intended to act as a prohibition rather than a tax, and the Government feared that it would be held invalid, the Treasury Department could not cure it by saying, "Well, we shall only collect taxes at half the rates indicated in the statute." This would be a direct trespass upon the legislative function of Congress. But that is exactly parallel to what the Treasury Department has done in one manner, in many cases, and the Board of Tax Appeals has done in another. They say, "We shall cure the absurdity of our theory by not carrying it to its logical conclusion

[69]See Appendix A, at pp. 55–59.
[70]*Edwards* v. *Slocum*, 264 U. S. 61, 63.
[71]As held by the Board of Tax Appeals in No. 130.

and shall abandon it after one round." In some cases the Treasury Department has applied the method of computation described in Appendix A[72] as the vertical truncated pyramid method. It has said the tax paid for 1917 is income for 1917, and an additional tax should be computed thereon, but this additional tax, although equally an income tax and equally payable by the lessee company, and although actually paid by the lessee company, will *not* be treated as further additional income to the lessor. And the Board of Tax Appeals has done the same thing, as we show in Appendix A,[73] except that it regards the 1917 tax as income for 1918. If their construction of the statute —that the tax on income is additional income—is correct, they have no jurisdiction to repeal the statute in part by saying that they will treat taxes on rent as income, but will not treat taxes on something "in the nature of rent" as income. *Both* must be taxes on income *or neither is*.

Government's counsel have attempted to justify this truncation of the pyramid by saying that they construe the lease to mean that the lessee will pay the first tax, but that the lessor will pay the second. A glance at the phraseology of the leases shows that this argument is without foundation. The lessee must pay *all* taxes on the lessor's income—and certainly it can not be claimed that the second exaction is not a tax on the lessor's income, without admitting that it is not an income tax, therefore not assessable under the income-tax law or the Sixteenth Amendment.

Similarly with the truncation adopted by the Board of Tax Appeals, if the 1918 tax must be computed on

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[72]See p. 59.

[73]See pp. 60–62.

the base of original income plus 1917 tax, and paid accordingly, there is no justification for saying that part, but not all, of the 1918 tax so paid constitutes income for 1919, to be added to 1919 rents in computing the 1919 tax.

VIII.

The Practical View.

The courts have always taken a practical, common-sense view in construing the word "income" as found in the Constitution and the statutes. What is the common-sense view of the situation presented here? The lessee took over the lessor's railroad long before the Sixteenth Amendment. It acquired complete control over it and assumed full responsibility for it. It did not buy the fee outright, but took a long term, for which it agreed to pay a fixed rental. The fact that the term was only for years and that the consideration for the conveyance was paid quarterly are the only differences between the situation that exists and that which would have existed if there had been an outright purchase of the fee. The lessee company treats the leased road exactly like its owned lines; it bears the upkeep, replacement, improvement costs; it pays the taxes and the operating expenses just as if it owned the road. It mingles the receipts with receipts from its owned lines and figures its gains or losses on the whole thing. The repairs and renewals the lessee must pay for, under the terms of the lease, are really its own repairs and renewals, made for its own benefit, and the taxes it pays are part of its operating expense.[74]

The obligation to pay the taxes was assumed by the

[74] *Galveston Elec. Co.* v. *Galveston*, 258 U. S. 388.

lessee for the reason that it alone would be in a position to pass them on to the rate-paying public.

The lease contained the usual provisions of long-term railroad leases. Because such leases have been generally used, and because Congress was familiar with the control, in one manner or another, of railroads, it must be presumed to have had full knowledge of the general features of such railroad leases when it enacted the Revenue Act of 1917.

This court has held that under the 1917 Act income should be computed in accordance with the method of bookkeeping employed by the taxpayer."

It certainly is not commercial usage, or the practice of railroads, to treat the income tax paid by the lessee as resulting in income to the lessor.

Article 127 of Regulations 33, Revised, the Treasury Department's interpretation of the 1917 Act, provides:

> "Approved accounting practices.—Pursuant to the foregoing provision, corporations keeping their accounts in strict accord with the methods prescribed by municipal, state or federal authorities, or in accord with approved standard accounting practices, consistently followed from year to year, will be permitted to make their returns of annual net income on the basis of the accounts so kept, provided such systems of accounting clearly and correctly reflect the net income of each year."

The books of account of the lessee and lessor companies are required to be kept in strict accordance with the classification of accounts and instructions of the Interstate Commerce Commission, promulgated under the authority conferred upon it by Congress.

It is assumed that the primary object of this classifi-

"*United States* v. *Anderson*, 269 U. S. 422.

cation of accounts, and the instructions pertaining thereto, is to have the true net income of railroad companies reflected by their books and records, and that such object has been attained.

The taxpayer's accounting is governed by the following instructions of the Interstate Commerce Commission:

> "Account 532, Railway Tax Accruals.
>
> "This account shall include accruals for taxes of all kinds (including Federal income tax) relating to railway property (including floating equipment, if any), operations and privileges, whether based upon the valuation of the property, the amount of stock and bonds issued or outstanding, gross or net earnings, dividends declared, number of passengers carried, quantity of freight transported, length of line operated or owned, rolling stock operated or owned, or other bases.
>
> "The taxes on leased property shall be included in this account by the carrier obligated to assume such expenses under the terms of the lease.
>
> "Note A: Taxes on leased property paid by one party to the lease and chargeable to the other party to the lease, shall be charged directly to the party bearing the expense and not included in the income account of the party first making payment."

Taxes paid by the lessee on the lessor's income, under the terms of the lease, according to Interstate Commerce Commission regulations are therefore proper charges against the lessee's operating income for the year in which they are paid or to which they apply. The instructions promulgated by the Interstate Commerce Commission do not provide for the inclusion in the lessor's income account of such taxes payable by the lessee, nor is it the practice, under the supervision of

the Commission, so to include the taxes in the lessor's income. On the contrary, those instructions affirmatively provide that such taxes shall not be reflected in the lessor's income. If such payment of taxes is to be regarded as additional income to the lessor, it will result in railroad corporations having to make their returns to show net income in a manner directly opposed to the accounting method prescribed by the Interstate Commerce Commission, and contrary to established commercial usage.

This court[11] has recognized that federal-income and excess-profits taxes are to be considered as operating expenses in the determination of rates. The greater the taxes, the larger the amount to be recovered from the public through rates for the service. Necessarily, the inflation of federal taxes upon a basis of fictitious (rather than actual) income, results in an excessive tax upon the lessee, which, in return, must be recovered from the public.

As we have shown under Point V above, this court took the practical view in *Edwards* v. *Slocum*, a parallel case involving the estate tax. We call the attention of the court to another parallel situation, arising under the excise tax provisions of the same revenue acts which impose the income and profits taxes and the estate taxes. The Revenue Act of 1918 imposed excise taxes upon the sale of specified articles. Sections 628 and 900 imposed taxes upon the manufacturer or producer; section 905 imposed taxes on the dealer; sections 904 and 907 imposed other taxes specifically upon the purchaser but required the seller to collect them. The purpose of Congress as expressed in Committee reports was twofold: to raise revenue and to discourage ex-

[11] *Galveston Elec. Co.* v. *Galveston*, 258 U. S. 388.

travagant spending during the war. Section 1007 of the Revenue Act of 1917, and sections 906, 1312 and 1319 of the Revenue Act of 1918 recognized that the tax might properly be passed on, in addition to the price. The Treasury recognized the difference between these two methods, and ruled that if the seller merely charged a higher price, he should compute the tax on the price charged, but if he billed the price and the tax separately, the tax should be computed on the net price, not on the total payment made by the purchaser. For example, Article 8 of Regulations 52, provided:

> "If the sales price of a taxable beverage is increased to cover the tax, the tax is on such increased sale price, but where the tax is billed as a separate item it is not to be considered as an increase in the sales price." cf. Sales Tax Ruling 495, C. B. II-2, p. 295, and Reg. 47, Art. 3.

Similar rulings were made with respect to automobiles, jewelry, candy and other articles with respect to the sale of which tax was imposed *on the seller*. The Circuit Court of Appeals for the Fifth Circuit, in *Elmer Candy Co.* v. *Fauntleroy* (24 Fed. (2d) 95), said:

> "The regulation of the Commissioner of Internal Revenue so construes the law, is fair, should have universal application and it should be given retroactive effect."

The base of the tax is not the full amount received, but that part of the amount received *as price* without increase for the tax, which is passed on with implied statutory authority, and assumed by the buyer in the same manner as the lessor's income taxes are assumed by the lessee here. The Government has litigated numerous cases on the question of whether the price and tax were sufficiently segregated in the bill to justify computation on the *net* price. But where the buyer wittingly paid the tax *as a tax*, although the statute

imposed it on the seller, even the Treasury Department has never suggested that it should be added to the price in computing the tax.[17] The clear justification for the regulations authorizing the vendor to pass on the tax without collecting a tax on the tax will be found in the statutes referred to above. Apparently all of those sections were not called to the attention of this court in *Lash's Products Co.* v. *U. S.* By sections 906 and 1312 (1) (2) (3), Congress itself passed the tax on to the vendee in those cases where by pre-existing contract the vendor had precluded himself from passing it on. By Section 1319 Congress recognized the right of the vendor to pass the tax on —through the process of imposing a penalty on him if he collected from the vendee *as tax* something that was *not* tax.

Congress relieved the vendor of the excise tax where he, without notice thereof, had so contracted that he could not pass it on. Surely it can not be presumed to have intended to *penalize* the far-sighted lessor who, *prior to the Sixteenth Amendment*, had contracted for the payment of any income taxes by the lessee, by the process of taxing him upon the taxes so paid under the lease.

In the excise taxes the *form* of the transaction is accepted as controlling. A seller can segregate price and tax and pay tax on price, not on price plus tax. The same is true of the estate tax, as we have shown.[18] Also with income taxes upon tax-free covenant bonds.

> "Taxes are very real things and statutes imposing them are estimated by practical results."[19]

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[17] See *Cliquot Club* v. *U. S.*, 13 Fed. (2d) 655, 18 Fed. (2d) 970; *Lash's Products Co.* v. *U. S.* (64 Ct. Cl. 252); *White Rock, etc., Co.* v. *Edwards*, 23 Fed. (2d) 539; *Elmer Candy Co.* v. *Fauntleroy, supra; Smith Grapejuice Co.* v. *U. S.*, 63 Ct. Cl. 140.

[18] *Edwards* v. *Slocum*, 264 U. S. 61.

[19] *Nichols* v. *Coolidge*, 274 U. S., 531, 541; 47 S. Ct. 710, 713.

IX.

Distinction between Lawful Avoidance and Illegal Evasion of Taxes.

Point IV of the Government's brief is entitled "*Evasion of income tax obligations would result if payment of tax by third persons were not taxed as income to person for whom paid.*"

This is the Treasury's old stand-by. It does not accuse the Boston & Maine and Fitchburg of conspiracy in 1900 to evade taxes under a law passed in 1917, but urges that to prevent evasion by others in the future, the statute must be given a construction, in connection with this old lease, which is contrary to common understanding and the results of which are absurd.

We do not ask for a decision that a contract made after 1913 need have the effect we claim for the lease of 1900.

Aside from that, however, we point out that avoidance of tax by legal forms has been common ever since "lease and release" was devised to avoid the Statute of Enrollments.[50] Examples could be multiplied indefinitely. The Revenue Acts are amended at every session of Congress to close loopholes by which taxes can be legally and legitimately avoided.

Though it be a device to avoid the revenue acts, and though its operation may have the effect of avoiding them, yet if the device be carried out by means of legal forms, it is subject to no legal censure.[51]

This should be a sufficient answer to the Govern-

---

[50] cf. Blackstone, Comm. II, 339.

[51] *U. S.* v. *Isham*, 17 Wall. 496.

ment's argument that a decision in favor of the taxpayer might show the way to others to avoid taxes.

X.

Principles of Construction Applicable.

The word "income" in the statute, as in the Constitution, should be construed in its generally accepted meaning. *Eisner* v. *Macomber*, 252 U. S. 189; *Lynch* v. *Hornby*, 247 U. S. 339, 344; *Merchants Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509; *United States* v. *Supplee-Biddle Co.*, 265 U. S. 189.

It is the long-established practice of the law not to regard the incidence of a tax in the levying of a tax. *Edwards* v. *Slocum*, 264 U. S. 61.

Algebraic formulae are not lightly to be imputed to legislators. *Edwards* v. *Slocum*, *supra*.

In case of doubt, taxing statutes are construed most strongly against the Government and in favor of the citizen. *Gould* v. *Gould*, 245 U. S. 151.

And the plain, obvious, and rational meaning of a statute is always to be preferred. *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364.

CONCLUSION.

The certified question should be answered in the negative.

Respectfully submitted,

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January, 1929.

APPENDIX A.

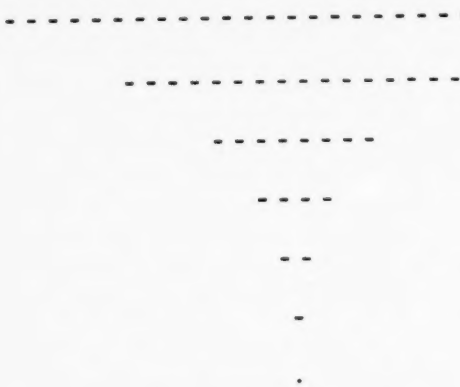
FIVE DIFFERENT METHODS OF COMPUTING TAXES UNDER THE GOVERNMENT'S THEORY EXPLAINED AND NAMED FOR PURPOSES OF DISCUSSION.

If the taxpayer is right in its contention that a Federal income tax paid by a lessee for a lessor under the terms of the lease is not to be regarded as income to the lessor for the purpose of calculating the lessor's Federal income tax, there is no difficulty in computing the tax. But, under the Government's theory that payment of the lessor's tax by the lessee constitutes taxable income to the lessor, five different methods of calculation have been offered as correct. It is regarded as advisable to describe these methods, and give each a name to simplify discussion of the merits of the underlying proposition and of the various methods, respectively.

(*1*) "*The Vertical Completed Pyramid Method.*"

First is the method adopted by the Government in computing the tax of the Fitchburg Railroad in the case at bar (No. 129). Under this method the 1917 tax is regarded as accruing in 1917, and the Government's underlying proposition is carried to its logical conclusion. The lessor's 1917 income from rents is taxed at statutory rates; this tax, being payable by the lessee, is regarded as additional 1917 income to the lessor, and an additional 1917 tax thereon is computed at statutory rates. The additional tax, being unquestionably an income tax, is equally payable by the lessee, and is therefore regarded as, in turn, further additional 1917 income to the lessor, and a further additional tax for 1917 is computed thereon, to be

assessed against the lessor but paid by the lessee. The process is continued until a final additional tax of less than half a cent makes it unnecessary to go any further. The process of pyramiding is carried through to the point where the additional tax is too small to be computed. It might be graphically illustrated thus:



The sum of all the lines constitutes the total tax to be assessed. For convenience, we shall call this method of computation the "vertical completed pyramid method." The tax may be found by a series of computations, or by a single computation based on a formula. Where the tax is computed by reference to income alone, as in the case of relatively small income, not subject to excess-profits taxes, the formula is simple. For example, in the case at bar, there was no excess-profits tax, and the income-tax rate was only 6 per cent. But the Government regarded the tax of 6 per cent on income of $1,023,700.93 or $61,422.06 as additional income *to the extent of $65,342.61*, see Record in this court, p. 2. Instead of starting with the rent income

of $1,023,700.93 and computing a 6 per cent tax thereon, a 6 per cent tax on that tax, another 6 per cent tax on that, and so forth, the Government merely divided the original income by .94, called the quotient taxable income, and computed the tax thereon at 6 per cent (see statement annexed to stipulation in the trial court).[52] That the result would be the same either way can be seen by comparing the following computations:

Income				Tax
$1,023,700.93	×	.06	=	$61,422.06
61,422.06	×	.06	=	3,685.32
3,685.32	×	.06	=	221.12
221.12	×	.06	=	13.27
13.27	×	.06	=	.80
.80	×	.06	=	.05
.05	×	.06	=	.00
$1,089,043.55	×	.06	=	$65,342.62

$1,023,700.93 ÷ .94 = $1,089,043.54. Income
$1,089,043.54 × .06 = Tax $65,342.61.

The discrepancy of one cent is due to dropping minor fractions.

The sum of taxes included in the vertical completed pyramid is a comparatively simple matter to compute where nothing but an original income and a fixed income-tax rate is involved. But when we get into excess-profits taxes, involving several factors—invested capital, prewar invested capital, average prewar income, income for taxable year, specific credit, excess-profits credit rate, several excess-profits tax rates, and income-tax rates, with specified inter-relations—it is no longer a simple matter.

[52]Record below, p. 27.

Let us take simplest possible example of the vertical completed pyramid method, applied to a tax upon income falling into only the lowest excess-profits tax rate indicated in the 1917 law. Assume a lessor railroad with $5,000,000 statutory "invested capital," having leased its property long before the war to a lessee railroad for $700,000 a year with the condition that the lessee should pay the lessor's taxes, the prewar income rate, involved in fixing excess-profits credits, assumed to be 9 per cent (the maximum).[53]

The first computation would be as follows:

Invested capital	$5,000,000.00		
9% thereof	$450,000.00		
Specific credit	3,000.00		
Excess-profits credit	$453,000.00		
Net income	$700,000.00		
Less:			
Excess-profits credit	453,000.00		
Taxable at 20%	$247,000.00	Excess-profits tax	$49,400.00
Net income	$700,000.00		
Less:			
Excess-profits tax	49,400.00		
Taxable at 6%	$650,600.00	Income tax	39,036.00
Total tentative tax			$88,436.00

This $88,436 of tax, being payable by the lessee, is regarded as income to the lessor, so we must begin over:

---

[53] If a lower prewar income rate be postulated the resulting taxes will be higher.

Original net income	$700,000.00		
Increase for tax	88,436.00		
Adjusted net income	$788,436.00		
Less:			
Excess-profits credit	453,000.00		
Taxable at 20%	$335,436.00	Excess-profits tax	$67,087.20
Adjusted net income	$788,436.00		
Less:			
Excess-profits tax	67,087.20		
Taxable at 6%	$721,348.80	Income tax	43,280.93
Total tentative tax			$110,368.13

But if the first tentative tax is payable by the lessee, the second is equally so payable, for it is equally covered by the provisions of the lease, so we will have to repeat the computation:

Original net income	$700,000.00		
Increase for tax	110,368.13		
Adjusted net income	$810,368.13		
Less:			
Excess-profits credit	453,000.00		
Taxable at 20%	$357,368.13	Excess-profits tax	$71,473.63
Adjusted net income	$810,368.13		
Less:			
Excess-profits tax	71,473.63		
Taxable at 6%	$738,894.50	Income tax	44,333.67
Total tentative tax			$115,807.30

The process must be repeated again and again until we reach a computation showing a result which differs from the previous one by less than half a cent. The successive computations under our example, following those given above, will show taxes respectively as follows:

$116,152.21
117,241.75
117,511.95
117,579.46
117,595.71
117,599.74
117,600.74
117,600.99
117,601.05
117,601.06

To carry the process any further would result in a change of less than half a cent, so we can stop.

Of course, the problem could be solved algebraically with less effort. The formula for a tax such as that in our example would be:

Let A represent the original income.

Let B represent the excess-profits credit.[11]

Let X represent the tax. Then—

$$X = \{ X + A - [(X + A - B) .2] .06 \} + [(X + A - B) .2].$$

If we had a case involving a higher rate of income as compared to invested capital, so that it became necessary to compute taxes at several different excess-profits tax rates, the formula would become necessarily more complex. The formula for a 1917 tax, on income taxable at all the rates provided by the statute would be:

Let A represent invested capital.

Let B represent excess-profits credit.

Let C represent original income.

Let X represent the tax. Then—

---

[11]An item in itself involving several factors, see § 203, quoted on p. 3, *supra*.

$$X = [(.15A)\ .2 + (.05A)\ .25 + (.05A)\ .35 + (.08A)\ .45 + (C + X - B - .33A)\ .6] + \{ C + X - [(.15A)\ .2 + (.05A)\ .25 + (.05A)\ .35 + (.08A)\ .45 + (C + X - B - .33A)\ .6] \{ .06.$$

This formula will give the tax where it is known that *all* the excess-profits tax rates will be reached. But if it is impossible to tell which rate will be the highest reached until we know what the final taxable income will be, it is necessary to adopt a much more involved formula, or go back to arithmetic and make anywhere from twenty to upward of eighty computations.

(2) *"The Vertical Truncated Pyramid Method."*

It is apparent that the "vertical completed pyramid method" of computing the tax, when applied to excess-profits taxes, involves calculations so extensive (if done arithmetically) or so involved (if done algebraically) as to be too absurd to be attributed to the intent of Congress. Probably because of this absurdity, the Treasury Department decided, *in some cases*, to avoid the absurdity by *not* carrying the theory to its logical conclusion. It said: "The tax on the original income of the lessor, payable by the lessee, will be regarded as additional income to the lessor, and an additional tax will be assessed thereon, but this additional tax will *not* be regarded as income to the lessor, even though the lessee pays it." The effect was to truncate the pyramid after the second computation, and to stop there.

So we call this second method of computation the "vertical truncated pyramid method."

Under the "vertical truncated pyramid method," the tax on the lessor's 1917 income is regarded as additional 1917 income to the lessor, and an additional tax

for 1917 is computed thereon. There the process stops. Graphically it may be illustrated:

- - - - - - - -

- - - -

That such a method constitutes a denial by the Government of its own theory, or a repeal of part of the tax imposed by Congress is shown under Point VI, p. 19, above.

(3) "*The Hybrid Method.*"

The third method is that adopted by the Government in one of the cases tried in the District Court with the case at bar—that involving the taxes of the Concord and Montreal Railroad (No. 2351 in the District Court). It is a composite of the two methods described above. In so far as the income tax at 6 per cent is concerned, the theory of treating taxes as additional income is carried to its logical conclusion—the pyramid is completed, through the process of dividing $610,050.02 by .94 and getting $648,989.38 net income—but when it comes to the computation of excess-profits taxes, the theory is *not* carried to its logical conclusion, but the pyramid is truncated. The result is that the total tax assessed, and indicated as payable by the lessee, the Boston & Maine Railroad, is $41,400.28, although the net income was increased for the purpose of making this computation by the difference between $610,050.02 and $648,989.38—only $38,939.36.[15]

We designate to this method of computation as the "hybrid method."

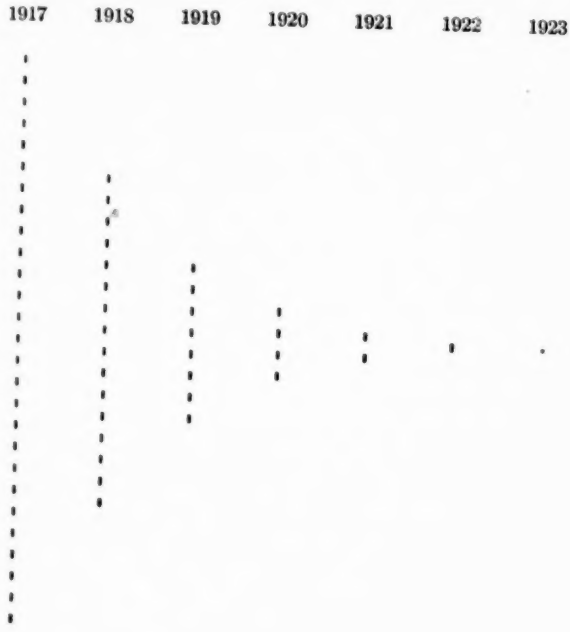
(4) "*The Horizontal Completed Pyramid Method.*"

The Board of Tax Appeals, in *Appeal of Providence & Worcester Railroad Co.*, 5 B. T. A. 1186, rendered an

[15] Record below, pp. 27–30.

opinion to the effect that the lessor's taxes, being payable by the lessee, constituted additional income to the lessor, but since they were not due and payable until the following year, they served to increase the lessor's taxes in the second year rather than the first. Upon the receipt of this opinion, counsel for both the Government and the taxpayer understood it to mean that the result would be as follows:

The 1917 tax would constitute additional 1918 income, and an additional 1918 tax would be assessed thereon. This additional 1918 tax would constitute additional 1919 income, and an additional 1919 tax would be assessed accordingly. The process would continue until the additional tax for some year was less than half a cent. The result might be graphically indicated thus:



We designate this fourth method of computation as the "horizontal completed pyramid method." It is the method that follows from carrying the reasoning of the Board's opinion to its logical conclusion. And it is apparent that under it future taxes for anywhere from ten to eighty-odd years would be affected by the payment of the lessor's tax in one year, depending on the various factors involved in the computation of the tax in each year.

(5) *"The Horizontal Truncated Pyramid Method."*

Apparently because of the absurdity of such a method of computation, the member of the Board before whom the final order in the *Appeal of Providence & Worcester Railroad Company* came for settlement, indicated that in his judgment the horizontal pyramid should be truncated, and he directed that the computation be made in a manner we may call the "horizontal truncated pyramid method," as follows:

The 1917 tax should be regarded as 1918 income and an additional 1918 tax assessed. The 1918 tax should be paid by the lessee as so computed, but only a part of the amount so paid should be added to 1919 income. For the purpose of computing the 1919 tax, the 1918 tax should first be recomputed on the basis of the rent income, without increase for 1917 taxes, and this recomputed 1918 tax (not the tax actually paid) should be added to 1919 income. Similarly, 1920 taxes should be based on 1920 rent income plus a 1919 tax (not that actually paid) recomputed to omit the 1918 tax from 1919 income. And so on.

The truncation of the horizontal pyramid in this manner involves two computations of each year's taxes—on one base for purposes of payment and on

another base for purposes of regarding it as additional income in the next year. Like the truncation of the vertical pyramid, it is based on the thought that an income tax on rent income is additional taxable income, but an income tax on such additional income is not further income. The lack of logic in both of these "truncated pyramid methods" is apparent.

APPENDIX B.

Boston & Maine Railroad *v.* United States.

Opinion of District Court, per Judge Lowell.[*]

This case was selected from several other similar ones to test the question whether the payment of the Federal income tax under a lease which provided for the payment of all taxes by the lessee subjects the lessor to a further tax on the sum of money so paid.

The case was tried on a stipulation of facts, which was essentially a restatement of the plaintiff's declaration. The following statement is taken almost verbatim from that declaration:

On June 30, 1900, the Fitchburg Railroad leased for the term of ninety-nine years all its railroad and property of every description to the Boston & Maine Railroad.

The lessee covenanted to pay all operating expenses of the lessor, including therein all repairs and renewals, all expenditures arising out of any contract, obligation, business, neglect, or misfeasance, or however otherwise arising, in any way connected with the ownership, use or operation of the demised premises, etc., including therein damages to persons or property, insurance, all taxes of every description, Federal, State and municipal, upon the lessor's property, business, indebtedness, income, franchises, or capital stock, or said rental, all expenses consequent upon or incidental to the renewal or refunding of the lessor's indebtedness or that of any road owned, leased, or operated by it, any expenditures hereinafter declared to be operating expenses, all necessary legal expenses of the lessor, and the organization expenses of the lessor.

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[*]Reported at 23 Fed. (2d) 343.

The lessee further covenanted to pay, as the same became due, the rentals of all railroads of which it came into possession or which it should operate under and by virtue of the lease and to pay the interest on the indebtedness of the lessor and on the indebtedness of all roads leased or operated by the lessor, which lessor was under obligation to pay, etc.

As rental for said lease, the lessee agreed to pay on the 1st day of October, 1900, and on the 1st days of each subsequent January, April, July, and October, during the term of the lease, to each holder of the lessor's preferred stock, exclusive of any in the lessor's treasury, $1.25 for every share held by him, and to each holder of the lessor's common stock, exclusive of any in the lessor's treasury, 25 cents for every share held by him, and, in case of any failure so to pay, each shareholder was to have a separate right of action against the lessee for the amount due to him. The lessee also provided the lessor with office accommodations, and paid $7,000 a year to defray its "organization expenses."

For the calendar year 1917, the said Fitchburg Railroad Company was assessed income, war profits and excess profits taxes under the Revenue Acts of 1916 and 1917 upon its income for the said calendar year amounting to $61,422.06 and in 1918 the said taxes were paid by its lessee, the Boston & Maine Railroad.

Thereafter, and on or about the 1st day of December, 1919, the Fitchburg Railroad Company was legally consolidated with the Boston & Maine Railroad, under and by virtue of the laws of the commonwealth of Massachusetts and of the States of Maine, New Hampshire and New York.

On or about the 26th day of February, 1921, the Commissioner of Internal Revenue assessed an ad-

ditional income tax upon the income of the Fitchburg Railroad Company for the calendar year 1917, amounting to the sum of $3,920.55; said assessment purporting to have been made under the Revenue Acts of 1916 and 1917 (39 Stat. 756, 40 Stat. 302) and further purporting to be taxes arising from inclusion by the Commissioner of Internal Revenue in the income of said Fitchburg Railroad Company for the calendar year 1917 of the amount of the taxes previously assessed for the calendar year 1917 upon said income and paid by said lessee, Boston & Maine Railroad, to wit, the amount of $61,422.06.

On or about the 20th day of July, 1921, the Collector of Internal Revenue at Boston, Mass., demanded payment of said additional taxes amounting to $3,920.55 within the period of ten days from date thereof, under threat of the penalties provided by law.

The Boston & Maine Railroad paid the tax under protest, and filed a claim for refund which the Collector of Internal Revenue neither allowed nor rejected, and, after the lapse of six months, the present suit was brought.

If the Government's contention is sound, the Treasury Department has discovered a manner of creating wealth—the age-long search for the philosopher's stone, which would turn into gold whatever it touched, has at last successfully ended. By merely laying the primary tax, the Department thereby creates income, which is subject to a secondary tax; this in turn is further income, which is subject to a tertiary tax; and this in its turn gives rise to a quaternary tax; and so on *ad infinitum*. This result is clearly shown in the opinion of Judge Morton in *U. S.* v. *Norwich & W. R. Co.* (D. C.), 16 Fed. (2d) 944, where a similar situation was pre-

sented, but not decided, as the decision turned on another point. Judge Morton says:

> "If the Government's right to the tax here claimed be sustained, the sum paid for this tax will constitute additional income of the defendant; on that income an additional tax would be assessable; the additional tax, when paid, would constitute further income of the defendant, on which another tax would be assessable; and so on. Counsel agree that, to compute the tax with mathematical precision, resort must be had to calculus. It is said in argument that, on one of the cases which depend on this, the total amount of the tax, if computed according to the Government's contention, will be over 200 per cent of the entire income."

[1] An objection of some force to this form of taxation is that it requires for its computation a complicated algebraic formula. See *U. S.* v. *Norwich & W. R. Co.*, *ubi supra*, *Edwards* v. *Slocum* (C. C. A.), 287 Fed. 651, 654, and *Edwards* v. *Slocum*, 264 U. S. 61, 63, 44 S. Ct. 293, 68 L. Ed. 564. But the Government's answer to this contention seems sound—that, if this be income, difficulty of computation is not a legal hindrance to the collection of a tax thereon.

The plaintiff objects to the tax on the ground that the money used to pay it is not income, as it was never received by the Fitchburg Railroad. This contention is unsound. *West End St. R. Co.* v. *Malley* (C. C. A.), 246 Fed. 625; *Rensselaer & S. R. Co.* v. *Irwin* (C. C. A.), 249 Fed. 726; *Houston Belt & Terminal Ry Co.* v. *U. S.* (C. C. A.), 250 Fed. 1; *U. S.* v. *Western Union Tel. Co.* (D. C.), 19 Fed. (2d) 157, and cases cited.

A more serious criticism is that the only source of income remaining to the Fitchburg Railroad is the

rental paid by the Boston & Maine, and that an income tax, paid as it was in the case at bar, is not regarded as rent. *Guild* v. *Sampson*, 232 Mass. 509, 122 N. E. 712; *Duffy* v. *Central R. Co.*, 268 U. S. 55, 63, 45 S. Ct. 429, 69 L. Ed. 846.

[2] The conclusive answer to the Government's contention, however, seems to be that there is no gain to the Fitchburg Railroad from the transaction. *Goodrich* v. *Edwards*, 255 U. S. 527, 41 S. Ct. 390, 65 L. Ed. 758. See also *Pitney* v. *Duffy* (D. C.), 291 Fed. 621, and *Duffy* v. *Pitney* (C. C. A.), 2 Fed. (2d) 230.

> "'"Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets.' *Eisner* v. *Macomber*, 252 U. S. 189, 207 [40 S. Ct. 189, 64 L. Ed. 521, 9 A. L. R. 1570]." Clarke, J., in *Merchants' Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509, 518, 41 S. Ct. 386, 388 (65 L. Ed. 751, 15 A. L. R. 1305).

The Fitchburg Railroad gets no gain or profit. It is not made richer by the tax so paid. Its financial situation is the same as when no income tax is laid, and continues the same however high the rate of such taxation may become. The opinion in the *Appeal of the Providence & Worcester R. Co.*, 5 B. T. A. 1186, which decided a question like the present one in favor of the Government, loses sight of this fact.

[3] The tax in the present case is also obnoxious to the cardinal rule that the incidence of a tax should not be considered in levying a tax. *Edwards* v. *Slocum* (C. C. A.), 287 Fed. 651, 655; *Edwards* v. *Slocum*, 264 U. S. 61, 63, 44 S. Ct. 293, 68 L. Ed. 564.

Judgment for plaintiff.

JAN
CHARLES EL

Supreme Court of the United States,

OCTOBER TERM, 1928.

No. 129.

THE UNITED STATES OF AMERICA

vs.

BOSTON & MAINE RAILROAD.

No. 130.

OLD COLONY TRUST COMPANY, *et al.*, EXECUTORS

vs.

COMMISSIONER OF INTERNAL REVENUE.

BRIEF FOR OLD COLONY TRUST COMPANY, *ET AL.*, EXECUTORS.

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Supreme Court of the United States.

OCTOBER TERM, 1928.

THE UNITED STATES OF AMERICA vs. BOSTON & MAINE RAILROAD	No. 129.
OLD COLONY TRUST COMPANY, *et al.*, EXECUTORS, vs. COMMISSIONER OF INTERNAL REVENUE.	No. 130.

BRIEF FOR OLD COLONY TRUST COMPANY, *ET AL.*, EXECUTORS.

Statement of Case.

In these cases the United States Circuit Court of Appeals for the First Circuit has certified a single question of law. This brief is filed by Old Colony Trust Company, *et al.*, Executors, appellants below in No. 130.

The decision of the United States Board of Tax Appeals in No. 130, from which the Old Colony Trust Company, *et al.*, Executors, appealed to the Circuit Court of Appeals, is published as *Old Colony Trust Company and Cornelius A. Wood, Executors of the Will of William M. Wood, deceased,* vs. *Commissioner of Internal Revenue,* 7 B. T. A. 648.

The Circuit Court of Appeals made no decision in the case but certified to this Court the single question of law involved in this case and in the *Boston & Maine Railroad* case. (Section 239 of the Judicial Code, as amended by the Act of February 13, 1925.) The question was certified on May 2, 1928 (Certificate, p. 1), and filed in the United States Supreme Court May 9, 1928 (Certificate, p. 4). The Court has jurisdiction to answer the question.

Lau Ow Bew v. *United States,* 144 U. S. 47.

The facts are set forth in the Certificate (pp. 1 to 3) and in the Government's brief, hence are not repeated here.

Question Certified.

Did the payment by the lessee in No. 2235 (No. 129), or by the employer in No. 2218 (No. 130), of the income taxes assessable against the lessor in the first case, and the employee in the second, constitute additional taxable income to such lessor or to such employee? (Certificate, p. 3).

The Statutes.

The *Boston & Maine Railroad* case arises under the Revenue Act of 1916 (39 Stat. 756) as amended by the Revenue Act of 1917 (40 Stat. 300). The *Old Colony Trust Company* case arises under the Revenue Act of 1918 (40 Stat. 1057). The pertinent provisions of these statutes are set forth in Appendix A.

Taxpayer's Position.

Taxpayers maintain that a contract for payment of income tax at the source is legal and proper; that rent or salary income is not commonly regarded as greater than the amount received, or due, merely because the income tax

upon it is paid by the payor rather than by the recipient of such rent or salary; that the fact that such income is received tax paid does not *inflate* or *increase* the amount of rent or salary received or derived, but merely preserves it intact without diminution; that the benefit derived is reflected in the *retention* of the gross rent or salary received, undiminished by income tax, not by an *addition* to such income; that the *income tax itself* is not commonly regarded as a gain or income which should be subjected to further income tax, merely because it is paid by some one else; that the incidence of the income tax is not considered in computing such tax; that the compounding or pyramiding of the tax resulting from the method of computation employed by the Government shows that the inclusion of the income tax itself in the income subject to tax is not within the general understanding of the term "income".

Income taxes paid at the source were not received constructively or otherwise by the recipient of the income because such taxes were not, could not and never would be received by the taxpayer. Cases holding that rent paid to a third party are income of the property owner are clearly not in point. Income tax is not rent or salary; an agreement to pay rent or salary free from income taxes is not the same as an agreement to pay a larger rent or salary; the rent cases do not involve consideration of the incidence of the tax or compounding of the tax; payment of income tax at the source is not the equivalent of a diversion of part of the rent or salary to a third party; the rent cases turned largely on a disregard of the corporate entity and the fact that the device employed by the lessors in such cases enabled them to evade all income taxes on the rent paid for the use of their property. The holding that rent for corporate property paid to the stockholders and bondholders is income of the corporation is of doubtful validity, has never been passed upon by this Court and, even were these cases analogous, they can not be extended to cover the radically different situation arising in the cases at bar.

ARGUMENT.

Rent or salary income is not commonly regarded as greater than the amount received or due merely because the income tax upon it is paid by the payor instead of by the recipient of the rent or salary, and such income tax itself is not commonly regarded as income.

(a) A contract that the payor of income shall pay the Federal income tax thereon, is a valid contract. Such contracts do not result in any tax evasion.

The shifting of the burden of a tax by contract is entirely legal and proper in the absence of a specific statutory prohibition of such contract.

> *American Express Company* v. *Michigan,* 177 U. S. 404.

The New York Personal Income Tax Law provides that a contract to bear or assume the burden of that tax shall be null and void (Section 385). The Federal Revenue Acts contain no such provision. In considering the 1917 Revenue Act the Senate Finance Committee proposed an amendment under Title XII, Income Tax Amendments, as follows:

> "Seventh. That any contract entered into after this act goes into effect, by which any person or concern agrees to pay any portion of the income tax of any other person or concern, shall be void." (Report of Senate Finance Committee, August 4 (Calendar day August 6), 1917, on H. R. 4280.)

The Congress did not adopt this amendment. On the contrary, it specifically recognized as legal and valid the most common class of such contracts, the tax-free covenants ap-

pearing in corporate bonds (see Section 1205, Revenue Act of 1917; Section 221, Revenue Act of 1918). Contracts that the payor of income should pay the income taxes thereon have long been common in corporate bonds and long term railroad and public utility leases, and there can be no question as to the validity of such contracts. Such contracts do not accomplish an evasion of taxes but give the Government double assurance of collection. The contracts here in question are of this character.

The statutory provisions that income taxes are not deductible from gross income (Sec. 1207(2) Revenue Act of 1917; Section 214(*a*)(3) Revenue Act of 1918) clearly were not intended to invalidate contracts making the income tax payable at the source, and indicate no intention that any taxpayer shall be taxed on more than his gross income. Their effect is merely to prevent the use of the tax itself in computing the income subject to tax.

The contract between the Boston and Maine Railroad and the Fitchburg Railroad was made in 1900 when there was no income tax. The resolution of the American Woolen Co. was adopted in August, 1916, when Federal Income Taxes were relatively unimportant. The Government concedes there was no intent to evade income taxes in either case.

If a contract for the shifting of the burden of the income tax from the recipient to the payor of the income gives rise to no additional income, as taxpayers maintain, no evasion of tax in fact results from recognizing the validity and effect of such contracts. If it is thought that the recognition of such contracts permits recipients of income legally to avoid some desired tax liability, the remedy lies in legislative prohibition of such contracts, a step which Congress considered but decided not to take.

(b) In common understanding income taxes paid by the payor of income neither increase such income nor constitute additional income.

The statutes under consideration contain no specific provision with respect to income taxes paid on salary or rent by the payor of such items but merely define "income" as including "gains, profits and income derived from salaries, wages or compensation for personal services of whatever kind and in whatever form paid * * * rent * * * or gains or profits and income from any source whatever". Sec. 2(*a*) Revenue Act of 1916; Sec. 213(*a*) Revenue Act of 1918.

In common understanding the full rent for 1917 received by the Fitchburg Railroad Company (the lessor in No. 129) for the use of its property, was the $1,023,701 which it actually received from the Boston and Maine, free and clear and subject to its control. The income tax of $61,422.06 stated in the certificate is 6% of $1,023,701. The rent of $1,023,701 was something of exchangeable value proceeding from the lessor's property, and received or drawn by it for its separate use, benefit and disposal. The payment of the income tax on the rent by the lessee did not increase the income of the lessor but merely left it unchanged. The income of the lessor from the lease was no greater when there was an income tax than before the income tax was imposed, and did not fluctuate from year to year as income tax rates were changed by Congress. The sole effect of the agreement by the Boston & Maine Railroad to pay the lessor's income tax on such rent was to enable the lessor to retain intact the entire rent of $1,023,701 received. The lessor did not pay a 6% income tax on this amount because the lessee had agreed to pay it, but the avoidance of this loss or expense did not increase its gain derived by $61,422.06 (6% of $1,023,701), or by $65,342.61 (the amount added to income by the Government, which is 6% of 100/94ths of $1,023,701),

or by any other amount. The benefit or advantage derived is fully reflected in the gross income received and retained. Taxpayer's advantage is that his gross income is not reduced by the income tax payment, not that his gross income is increased by the income tax payment. The avoidance of a loss or expense merely operates to preserve, not to increase income. A measure taken to prevent the diminution of the income received does not have the effect of increasing such income. A penny saved is not the legal equivalent of an additional penny earned. A saving of outgo is not an increase in income.

The salary of Mr. Wood in No. 130 upon which his employer paid the income tax did not thereby become a greater salary any more than a salary exempt from State or Federal income tax is inflated by the amount of the tax saving. No one would contend that a Federal employee residing in New York and exempt from New York income tax on his Federal salary, should on that account be subjected to a Federal income tax on something more than his salary. Nor does any one suggest that a Federal Judge, exempt from both Federal and State income tax on his salary (*Miles* v. *Graham,* 268 U. S. 501) derives income from his services in excess of his salary because of such exemption from tax. The fact that such salary cannot be diminished by an income tax does not mean that the salary is increased by the amount of tax which would have been imposed on some one else not so favorably situated. When there is a 10% income tax, there is certainly no common understanding that $100 of exempt or tax paid salary received represents either $110 or $111.11 of income.

Interest income from a bond is the amount of the coupon which is cashed, whether the bond is a municipal bond, the interest on which is exempt from income tax, or a tax-free covenant bond, where part of the income tax on the interest is paid at the source, or an ordinary bond, the interest on which is subject to the full income tax. It is settled that the interest received on a tax-free covenant bond is no greater

in amount because part of the income tax liability on such interest is paid at the source by the obligor corporation, and that the tax so paid is not additional income to the recipient of the interest.

Duffy v. *Pitney*, 2 F. (2d) 230. Certiorari denied, 267 U. S. 595.

In the case cited the Circuit Court of Appeals for the Third Circuit held that the part of the bondholder's income tax paid at the source by the corporate obligor of a tax-free covenant bond was not income to the bondholder, and said:

> "Applying the customary canons of construction to this tax legislation (Spreckles Sugar Co. *v.* McClain Collector, 192 U. S. 397, 24 S. Ct. 376, 48 L. Ed. 496; Gould *v.* Gould, 245 U. S. 151, 38 S. Ct. 53, 62 L. Ed. 211), we do not believe in such case that the sum withheld at the source is income. It does not fall within any accepted definition of the term. Eisner *v.* Macomber, 252 U. S. 189, 207, 40 S. Ct. 189, 64 L. Ed. 521, 528, 9 A. L. R. 1570, 1577. It is not a 'gain' or 'profit' derived from any of the sources named in the statute (Section 213), nor (whatever it is) has it ever been 'received' by the taxable. It is not property nor is it a right to property for, not being payable to the obligee, he cannot recover it in an action at law against the obligor. In its effect upon the obligee it is at most an intangible but very real advantage for which he has contracted and as a result of which a part of his taxes is paid by another. In thus contracting for the payment of a part of his tax by another the taxable in this case did only what Congress expressly permitted him to do. Therefore his conduct was lawful and was in no sense an evasion of the payment of taxes or an obstruction to the collection of taxes, as in some cases relied upon by the defendants. Houston Belt & Terminal Railway Co. *v.* United States, 250 F. 1, 162 C. C. A. 173; Blalock *v.* Georgia Railway & Electric Co., 246 F. 387, 158 C. C. A. 451; Rensselaer & Saratoga Railroad Co. *v.* Irwin (D. C.) 239 F. 739; Id. 249 F. 726, 161 C. C. A. 636. We are of opinion, therefore, that the sum withheld at the source in obedience to the statute is a tax. The best authority for this is the statute itself, and the statute

calls it a 'tax'. Being a tax, we cannot find that the Revenue Act requires that it be included in a return as 'income' and that the act intends thus to impose a tax upon income and also a tax upon a tax."

This case is squarely in point here, and is followed by the Treasury Department, the Board of Tax Appeals and the Courts, and is not questioned by the Government in its brief in this case.

Treasury Decisions 3685, C. B. IV-1, p. 121;
Appeal of Mary Clark Kling, 1 B. T. A. 1048;
Geo. D. Horst v. *United States, No. E-89, Ct. of Cl.*, Jan. 16, 1928;
Jno. D. Horst v. *United States, No. E-90, Ct. of Cl.*, Jan. 16, 1928.

The Government attempts to distinguish *Duffy* v. *Pitney, supra,* on the ground that there the obligor was discharging a statutory duty and in effect paying its own income tax (Government's brief, p. 16). *It is obvious however that the tax paid by the obligor under a covenant to pay bond interest without deduction for income taxes, is the income tax of the bondholder, not of the obligor.* By the statute the bondholder is allowed to take credit for such payment as a part payment of his income tax and the obligor is not required to pay the tax unless the bondholder is subject to tax. The statute certainly does not attempt to impose an income tax on the obligor measured not by its income but by the bond interest paid out. Any such income tax would be invalid.

Section 221, Revenue Act of 1918, Appendix A, p. 31 hereof.
Law Opinion 1107, C. B. I-2, p. 223.
G. C. M. 1710, C. B. VI-1, p. 145.
Frew v. *Bowers*, 12 F. (2d) 625.

See *Union Pacific R. Co.* v. *Bowers*, 28 F. (2d) 370, expressly holding that the bondholder and not the obligor is the taxpayer in such a case.

In the cases at bar as in *Duffy* v. *Pitney, supra*, the contract was valid and enforceable and the conduct of the parties was lawful. *The express statutory recognition of the tax-free covenant in corporate bonds adds nothing to their validity and does not change in any respect the character or effect of the benefit derived by the recipient of the income. The fact that the obligor was discharging a statutory duty and was not allowed to deduct the tax paid at the source by it, had absolutely no effect on the nature or taxability of the benefit derived from the transaction by the bondholder.* The provision of the Revenue Act of 1921 that the tax paid at the source was not income of the obligee could not, of course, directly affect the decision in *Duffy* v. *Pitney* which arose under the Revenue Act of 1918, which was silent upon the question. Such provision of the 1921 Act indicates that Congress did not consider the income tax paid at the source as giving rise to any benefit to the recipient of the tax paid income, which should be treated as additional income. The Government has wholly failed to distinguish *Duffy* v. *Pitney, supra*. That decision is squarely in point and its correctness is not questioned.

It is not sufficient to say, as the Government does in its brief, that the income taxes in question were paid by the lessee as part of the consideration for the use of the leased property or by the employer on account of services. The tax paid at the source by the obligor of a tax-free covenant bond was not treated as income of the bondholder though unquestionably, so far as the obligor was concerned, it was an additional payment for the use of the bondholder's money. The question is not as to the motive or reason for the making of the income tax payments to the tax collector by the lessee or employer but whether the lessor and employee received *income* by reason of such payments. That such income tax payments were

not received by the taxpayers "constructively" or otherwise, is shown elsewhere in this brief (*infra*, p. 26). What we contend here is that the income taxes paid to the Government were not income, salary or rent to the taxpayers in the ordinary sense and common understanding of those terms.

It is, of course, well settled that the general term "income" used in the statute must be construed in the ordinary sense of the word as used in common speech, and the question here presented must be decided on the basis of the common understanding as to what constitutes income and is usually classed as such.

Eisner v. *Macomber*, 252 U. S. 189.
Lynch v. *Hornby*, 247 U. S. 339.
United States v. *Supplee-Biddle Hardware Company*, 265 U. S. 189.
The Merchants Loan & Trust Company v. *Smietanka*, 255 U. S. 509.

The terms "rent" and "salary" used in the statute must likewise carry their ordinary sense and meaning. The statutory definition of income as including "gains, profits and income derived from salaries, wages, or compensation for personal services of whatever kind or in whatever form paid", merely states the general understanding of the term, was not intended to include in taxable income something not generally regarded as income, or salary or wages, and could not be effective to tax as income something not commonly regarded as income.

Eisner v. *Macomber, supra.*

The taxpayer, of course, derives a benefit from having the income tax on the rent or salary paid by another, but it is clear that benefits are not necessarily income.

Eisner v. *Macomber*, 252 U. S. 189.
Baldwin Locomotive Works v. *McCoach*, 221 Fed. 59.
Gould v. *Gould*, 245 U. S. 151.

Solicitor's opinion 132, C. B. I-1, p. 92.
Treasury Decision 2747.
Edwards v. *Cuba Railroad*, 268 U. S. 628.
Appeal of Liberty Light & Power Company, 4 B. T. A. 155.
Appeal of Great Northern Railway Company, 8 B. T. A. 225.
Jones v. *United States*, 60 Ct. Cl. 552.
Bowers v. *Kerbaugh Empire Company*, 271 U. S. 170.

Life insurance received by a corporation on the death of an officer is not income because not "usually classed as income".

United States v. *Supplee-Biddle Hardware Company*, 265 U. S. 189.

There is no income where corporations avoid payment of the face amount of bonds by purchasing such bonds at less than face value.

Appeal of Independent Brewing Company, 4 B. T. A. 870.
Appeal of New Orleans, Texas & Mexico Railroad Company, 6 B. T. A. 436.
Appeal of Houston Belt & Terminal Company, 6 B. T. A. 1364.
Appeal of National Sugar Manufacturing Company, 7 B. T. A. 577.
Appeal of Meyer Jewelry Company, 3 B. T. A. 1319.
Solicitor's Memorandum 1495, C. B. III-1, p. 108.

It is clear from these cases that the mere fact that a taxpayer avoids payment of a debt or liability, or is otherwise benefited, does not necessarily mean that he has derived taxable income. It must also appear that the taxpayer received or derived a gain from the transaction which is commonly regarded as income. And the benefit derived by the lessor or employee from having the income tax paid at the source is not commonly regarded as income.

It is true that in many cases the payment of an employee's debt by an employer may be income to the employee. This may be true of pre-existing debts, or debts arising out of extraneous transactions. But in the cases at bar the recipient does not secure the payment of a pre-existing and extraneous debt, payable whether he received the income or not; he merely avoids paying out part of the income received to satisfy the income tax liability on such salary, a liability which he would not have incurred but for the receipt of such salary. He does not avoid payment of a debt representing money, or food, or some other positive benefit received or to be received by him; he merely stipulates that he shall not have to pay a charge incident to the receipt of the income which, when paid, represents no positive benefit to him at any time. He merely arranges to retain the full income upon which the tax is paid. The benefit or advantage which the employee derives from such a transaction does not represent any gain commonly classed and regarded as income.

(c) The incidence of a tax is not considered in measuring that tax.

In the cases at bar the Government has added the income tax payable by the lessee and employer to the income received by the taxpayers and has thus imposed an income tax on the income tax itself. The fact that a tax on a tax is imposed is not changed by claiming that such tax is income. *The government has, in these cases, increased the income subject to tax merely because the burden of such tax is shifted by a valid contract to the payor of the income.*

It is established by this Court that the incidence of the tax, *i. e.*, where the burden of payment falls, is not to be considered in determining the measure of such tax. Tax statutes are normally construed in such a way that the measure of the tax is first determined, and the tax thereon is then computed by simple arithmetic. The mind instinctively rejects

the complicated idea of taking into account the amount of the very tax which is to be determined as a part of the measure by which such tax is to be computed, or of considering the effect of the payment of the tax in computing it.

This principle is set forth in *Edwards* v. *Slocum*, 264 U. S. 61. The estate tax law provided that gifts to charities were deductible in determining the net estate. In this case the residuary estate was given to charity, and under the terms of the will and the State law, the Federal estate tax was payable out of the residuary estate. The executors claimed the right to deduct from the gross estate as a gift to charities the amount of the residuary estate as computed before payment of the Federal estate tax. The Government contended that only the amount which would actually be received by the charities, the residuary estate less the Federal estate tax, could be deducted. Rejecting the Government's contention, this Court said:

> "It [the statute] levies a sum equal to a certain percentage of the value of the net estate, and provides the criteria by which the net estate shall be ascertained. It thus manifestly assumes that the net estate will be ascertained before the tax is computed. The Government offers an algebraic formula by which it would solve the problems raised by two mutually dependent indeterminates. It fairly might be answered, as said by the Circuit Court of Appeals, that 'algebraic formulae are not lightly to be imputed to legislators,' but it appears to us that the structure of the statute is sufficient to exclude the imputation. As further remarked below, the theory departs from the long established practice of the law not to regard the incidence of a tax in the levying of a tax, * * *."

In the Circuit Court of Appeals in the same case, the Court said:

> "History, so far as we can discover shows no other instance of attempting to measure a tax *pro tanto* by itself" (287 Fed. 651).

The fact that the burden of the tax falls on the charitable bequest because of an express provision of the will, an act of the testator, does not change the rule.

Clark v. *United States,* 27 Fed. (2d) 887.

The Treasury Department and the Courts have recognized that the manufacturer may shift the burden of a sales tax measured by selling price, without increasing the measure of the tax, if he clearly indicates that he is billing the customer for the tax and is not merely increasing the selling price, although there is some disagreement as to how far the seller must go to bring himself within this rule.

Article 8, Regulations 52.

Clicquot Club v. *United States,* 13 F. (2d) 655.

White Rock Mineral Springs Co. v. *Edwards,* 23 F. (2d) 539.

Elmer Candy Co. v. *Fauntleroy,* 24 F. (2d) 95, Certiorari granted 72 L. Ed. 682.

Lash Products Co. v. *United States,* D-412, Ct. Cl., November 7, 1927, certiorari granted 72 L. Ed. 682.

By the weight of authority and practice, state inheritance taxes are computed without reference to the incidence of the tax, and a provision of the will, or local law, that all inheritance taxes shall be paid out of the residue, does not, for tax purposes, increase the specific legacies or reduce the residue.

Matter of Estate of Swift, 137 N. Y. 77.

People v. *McCormick,* 327 Ill. 547.

Gleason & Otis, Inheritance Taxes, 1922, p. 87.

The Government discusses the leading case of *Matter of Estate of Swift, supra,* in its brief (p. 17), but, we submit, wholly misapprehends the decision. The Government quotes from Judge Gray's opinion, in which he stated that the tax was a tax on property and not on the legatee, but fails to

note that the majority of the court did not agree with Judge Gray on this point, as is shown by the last few paragraphs of the opinion. However, it is the court's decision on the effect of a provision that all inheritance taxes should be paid out of the residuary estate, which is of importance here. As to this the court said (p. 87):

> "The appraiser, in ascertaining the value of the residuary estate for the purpose of taxation, deducted the amount of the tax to be assessed on prior legacies. The surrogate overruled him in this, and held that there should be no deduction from the value of the residuary estate of the amount of the tax to be assessed, either upon prior legacies, or upon its value. He held that the legacies taxable should be reported, irrespective of the provision of the will, and that a mode of payment of the succession tax prescribed by will is something with which the statute is not concerned. I am satisfied with his reasoning and can add nothing to its force."

This portion of Judge Gray's opinion was the decision of the court. This is an express decision, made in 1893, that in determining the value of legacies for collateral inheritance tax purposes the incidence of the tax is not to be taken into account, and this, we understand, has generally been recognized as the law.

Two recent decisions are the only authorities to the contrary:

In re Irwin's Etate, 196 Cal. 366 (1925).
In re Levalley's Estate, 191 Wis. 356 (1926).

The reasoning of the California and Wisconsin courts is directly opposed to the reasoning of this Court in *Edwards* v. *Slocum.* No authorities are cited in support of the decisions, and the decisions are opposed to the long established practice. The fact that it was not until 1925 that any court took the position that the incidence of the inheritance tax affected the amount of the taxable legacies is persuasive evidence that such a principle is contrary to common under-

standing. Ordinarily the courts assume, without discussion, that the incidence of the tax does not affect the computation.

In re Frick's Estate, 277 Pa. 242; 121 Atl. 35. Reversed in part in *Frick* v. *Pa.,* 268 U. S. 473.

In re Lea's Estate, 194 Pa. St. 524; 45 Atl. 337.

Isham v. *New York Association for the Poor,* 177 N. Y. 218.

Dugan v. *Miles,* 276 Fed. 401.

The position taken by the Government in this case is directly opposed to the settled principle that the incidence of the tax does not affect the measure or amount of the tax.

(d) The compounding or pyramiding of the tax which results from the logical application of the Government's theory shows that the result of such theory is not within the common understanding of income.

The Government's theory that the initial income tax paid at the source is additional income upon which a further income tax is payable, necessarily involves the conclusion that the second tax, if payable by the payor of the income, is also additional income subject to a further income tax, and so on *ad infinitum.* It is not correct to say, as the Government does in its brief, that taxpayers are objecting that they are not taxed enough. Taxpayers are objecting to being taxed at all on a construction of the term "income" which leads to such startling and unusual results as to show that no part of the income tax paid at the source falls within the common and general understanding of the term "income".

The Government seeks to avoid the undoubted force of this argument on the ground that the certificate does not raise the question. The certificate in the *Boston & Maine* case, however, does clearly raise this question. The certificate states, at page 2:

> "In 1918 an income tax return, under the provisions of the Revenue Acts of 1916 and 1917, was filed on

behalf of the Fitchburg Railroad Company for the calendar year 1917 upon which taxes amounting to $61,422.06 were assessed. These taxes were paid to the Commissioner of Internal Revenue by the Boston & Maine Railroad pursuant to the terms of the lease. * * *

In 1921 the Commissioner of Internal Revenue assessed an additional income tax against the Fitchburg Railroad Company of $3,920.55. In doing this he treated the payment of $61,422.06 made by the Boston & Maine Railroad to the Collector of Internal Revenue as additional taxable income to the Fitchburg Railroad Company to the extent of $65,342.61."

The corporate income tax rate in 1917 was 6%. The Commissioner did not merely treat the initial income tax of $61,422.06 as additional income of the lessor and assess a tax of $3,685.32 (6% thereof), as the Government appears to imply in its brief; he treated the payment of $61,422.06 as additional income to the extent of $65,342.61 and assessed an additional tax of $3,920.55 (6% thereof). These figures are comprehensible only if it is explained, as the Government does in its brief (p. 26), that the tax computed is 6% of 100/94ths of $61,422.06. In the *Boston & Maine* case the Government carried its theory to its ultimate limits. It treated as accrued income of 1917, not only the primary income tax of $61,422.06, but a secondary income tax of $3,685.32, and a tertiary income tax of $221.12, and so forth, until the total of $65,342.61 added to income was accumulated (see Government's brief, p. 27). The question of compounding the income tax thus arises directly on the face of the certificate in the *Boston & Maine* case.

This question does not arise directly in No. 130 because the taxpayer there was on a cash receipts and disbursements basis, so that the question of taxing the secondary tax will not arise unless and until such secondary tax is actually paid by the employer. But the question is of direct importance in No. 130 because every reason which the Government is now urging in support of its ruling that the primary income tax paid by the employer is income of the employee, will apply

with equal force to support a claim that the secondary, tertiary, etc., income taxes, when paid by the employer, will be income to the employee.

In both cases the Government has taxed the maximum amount possible under the system of accounting employed by the respective taxpayers.

The startling and unusual results of the Government's theory as actually applied in the *Boston & Maine* case, and for the application of which this case will be a controlling precedent, if decided in favor of the Government, appear from the following:

If the Government's theory is sound it must apply not only to the simple case of a 6% income tax, but also to cases subject to the more complicated excess profits tax provisions of the Revenue Acts of 1917, 1918 and 1921, and to the cases of individuals subject to progressive surtaxes, as well as normal taxes, under all of the Revenue Acts.

If the Fitchburg Railroad Company had an invested capital for 1917 of but $2,000,000 and received annual rent of $1,023,701, its total tax under the taxpayer's theory, based on the income of $1,023,701, would be $416,385.42. The total tax on the Government's theory would be the astounding figure of $1,107,408.04, based on a theoretical income of $2,131,-109.03. This tax under the Government's theory can be computed arithmetically by a series of tax computations (39 in this case) in each of which the tax shown by the previous computation is added to the actual income. Or the tax can be computed, in some cases, by resolving a formula, in which X equals the tax and X plus the actual income equals the theoretical income (see Appendix B for details). The Government's formula, computing the tax at 6% of 100/94ths of the income, can, of course, be used only in the simple case of a flat income tax rate.

In the case of an individual reporting on the accrual basis and receiving a salary of $1,000,000 for 1918, upon which the employer had agreed to pay all income taxes, the tax, on the taxpayer's theory, would be $703,150 on a net income of

$1,000,000, and the tax, on the Government's theory, would be $3,057,173.91 based on a theoretical net income of $4,057,173.91 (see Appendix C for details). In this case the tax would be more than three times the tax paid income.

If the income tax payable by another accrues when it becomes payable in the year following the accrual of the income, the details of the computation are different but the compounding of the tax remains. If, for example, it should be held that the tax on the 1917 income of the lessor was accrued income for the year 1918 when it became payable (see *Appeal of Providence & Worcester Railroad*, 5 B. T. A. 1186), the primary tax would be accrued income for 1918, the secondary tax would be accrued income for 1919, and this process would continue for a series of years until the last compounding of the tax was less than half a cent. Each year's rent would start such a series in operation, and to get the accumulated theoretical income for any year it would be necessary to consider the annual rent and the compounding of the tax thereon under various tax laws for a long series of prior years (see Appendix D for details).

The same result would follow in the case of a taxpayer computing income on a cash basis, as in the *Old Colony* case, except that here the income tax paid by the employer would only become income in the year when actually paid, so that in case of delayed payments the final compounding of the tax would spread out over a somewhat longer period.

The Government has not conceded that its computation in the *Boston & Maine* case was wrong and does not take the position that it should have collected an additional tax of but $3,685.32 (6% of the initial tax of $61,422.06) instead of the tax of $3,920.55 which it actually collected and seeks to retain. The Government's brief, however, is based on the assumption that no attempt has been made to collect further taxes upon the theory that the payment of additional taxes creates further income and maintains that

> "the Treasury Department is not fairly to be censured if it fails to apply its theory literally in order to avoid absurd consequences" (p. 21).

In making this statement the Government apparently recognizes that literal application of this construction may lead to results which are absurd.

If the logical application of the Government's theory leads to results which are manifestly absurd, that shows that the theory is wrong, and hence such theory furnishes no proper basis for the collection of any additional tax. The use of a theory leading to absurd results is not to be defended by the suggestion that in practice the Treasury will not press the theory too far.

The Government maintains that any compounding of the tax results from the contract of the parties, rather than from the Government's theory. *The mathematical difficulty, however, is inherent in and characteristic of the principle of considering the incidence of the tax in measuring the tax.* The argument was made in *Edwards* v. *Slocum* that the mathematical difficulties existing there did not result from the provisions of the law but from the provisions of the testatrix's will. As to this the Circuit Court of Appeals said (287 Fed. 654):

> "It is next observable that this using of tax to measure tax will only happen when the residuary estate, or some part of it, is devoted to charity or other deductible purpose. If this testatrix had made her charitable bequests before inserting a residuary clause, no difficulty would have arisen. It is argued with apparent seriousness that this is 'something for which the testatrix is responsible,' which is true only if the law laid such a trap as this for charitable residuary legatees, as distinguished from equally charitable general legatees—again something not lightly imputable to the lawgiver."

See also *Clark* v. *United States*, 27 F. (2d) 887.

There is no way in which the parties could have framed a contract which would accomplish the entirely proper result of assuring a fixed rent or salary free from diminution by possible income taxes, which would not, under the Government's theory, involve compounding of the tax. The Government's suggestion that the question of compounding

would not arise if the lease had provided for the payment of $61,422.06 to cover the 1917 income tax of the lessor, does not take care of the situation. If this amount was additional income the lessor would have to pay a tax of $3,685.32 thereon and would either net that much less than the parties intended by their contract or, if the lessee agreed to pay such tax, the precise question at issue would arise. If the lessee and Mr. Wood had included the initial income tax payments in their original returns for the years involved, the lessee and employer would have to pay the secondary income taxes thereon and the question of compounding would immediately arise. The Government has indicated no method by which the parties could contract for a fixed rent or salary free from diminution by possible future income taxes or increases in income tax rates which would not give rise to a compounding of the tax if the Government's theory is to be adopted that the incidence of the tax affects the measure of the tax. The unusual results of the Government's theory therefore cannot be justified on any ground that the parties are responsible for such results because they should have foreseen that the Government would depart from the long established usage of not regarding the incidence of a tax in determining its amount, and should have framed their agreements so that the lessor or employee would bear some part of the tax burden and thus avoid the compounding resulting from the Government's theory.

The fact that the Government's theory leads to this compounding of tax and to startlingly large taxes in normal cases, is highly significant as indicating that the amounts produced by the Government's method of computation are not within the ordinary concepts of income. The force of this argument rests not so much on the fact that the Government's computation in many cases requires the use of complex and involved mathematics, as it does on the consideration that the result, computed in this complicated way, produces an amount which would not be considered income within the ordinary usual general understanding of that term.

(e) The income tax paid at the source is not constructively received by the recipient of the income. Cases holding that rent paid to a third party at the lessor's direction, is income of the lessor, turn on facts and reasons not present in the case at bar.

The Government contends that the agreements of the lessee and employer to pay the rent or salary free from income tax were in effect agreements to pay the amount of the income taxes as additional rent or salary, that if such amounts had been paid to the lessor or employee as rent or salary, they would clearly be taxable income, and that taxpayers must account for such additional rent or salary income just as if in fact received, since such amounts were paid out to a creditor of the taxpayers at their direction. In support of this contention the Government cites cases holding that *rent* paid to a third party at the lessor's direction is income of the lessor.

Hamilton v. *Kentucky & I. Terminal Co.* 289 Fed. 20.

West End Street Railway Company v. *Malley*, 246 Fed. 625 (1917); certiorari denied 246 U. S. 671.

Rensselaer & Saratoga Railroad v. *Irwin*, 249 Fed. 726 (1918).

Northern R. Co. of New Jersey v. *Lowe*, 250 Fed. 856 (1918).

Houston Belt & Terminal Company v. *United States*, 250 Fed. 1 (1918).

Blalock v. *Georgia Railway etc. Company*, 246 Fed. 387 (1917).

American Telegraph & Cable Co. v. *U. S.*, 61 Ct. Cl. 326 (1926).

United States v. *Western Union Telegraph Co.*, 19 F. (2d) 157 (1926).

The Government also cites *Appeal of Providence & Worcester R. R. Co.* 5 B. T. A. 1186, the decision of the Board of Tax Appeals upon which its decision in No. 130 below was based.

The Government's contention is unsound as applied to this case and the cases cited are clearly distinguishable for the following reasons:

This contention of the Government was rejected in *Duffy* v. *Pitney, supra.* There the Government contended that the tax paid at the source by the obligor on a tax-free covenant bond should be treated as additional interest on the bond, paid for the use of the bondholder's money, and paid to satisfy the bondholder's tax liability. These same lessor-lessee cases were relied upon, but the Court decided against the Government and that decision is now generally accepted.

The amounts here in question are income taxes and not rent or salary income. The lessee did not agree to pay an increased rent if an income tax was imposed. It agreed to pay the same rent for all years, and to pay any income taxes which might be imposed thereon, a very different arrangement. The lessor demanded a fixed rent, which should be free from reduction by income taxes, and the arrangement made was the only practicable arrangement to assure this proper result. The same was true of the tax paid salary contract. The agreement was not to pay a larger salary, but to pay the income taxes so that the employees would "receive their salaries in full without deduction on account of income taxes." The parties properly and correctly called the amounts in question income taxes, and such amounts were paid to and received by the Government as income taxes. Since these amounts are correctly described as income taxes they cannot properly be treated as rent or salary. The question is not whether rent paid to a third party at the direction of the lessor is income to the lessor, which was the question decided in the cases cited, but the question is whether income tax paid at the source by the payor of the income is income of the

taxpayer, which was the question decided against the Government in *Duffy* v. *Pitney*.

An agreement by the lessee to pay to the Government any income tax on the rent is fundamentally different from an agreement by the lessee to pay the rent to stockholders or bondholders of the lessor because the tax agreement shifts the burden of the income tax from the lessor to the lessee. It is only in such a case that there comes into play the long established principle that the measure of the tax is not affected by its incidence. It is only in such a case that the Government's theory leads to a compounding of the tax. The lessor-lessee cases cited did not, of course, involve this question at all.

The cases at bar do not involve the payment of salary or rent which would normally be payable to the taxpayer in any event, but are paid with his consent direct to his nominee. These cases involve income taxes, amounts which are never payable to the lessor or employee under any circumstances, which are payable at all only when and to the extent that an income tax is levied, and which are payable, in any event, only to the tax collector. This is a radically different situation from an assignment or diversion of amounts which would normally come to the taxpayer as income.

In the cases cited the courts relied very largely on a disregard of the corporate entity. With respect to dividends they held that the stockholders were the real beneficiaries of the corporate activities, and that the receipt of income by the stockholders, representing rent for the use of the corporate property, was equivalent to the receipt of such income by the corporation, which was merely a fictitious person representing the stockholders. No such consideration, of course, is involved in the cases at bar.

In the cases cited the courts took the view that the provision for payment of the rent direct to the stockholders and bondholders of the lessor was an improper evasion of the lessor's income tax due on the rent, recognized by every one as the income of the owner of the rented property. In the

cases cited the Government would have collected no income tax at all on the rent if the lessors were allowed to divert the rent for their property to their stockholders and bondholders and the corporate income tax in all such cases could have been completely evaded. Here the full income taxes on the entire rent and salary received by the lessor and employee are paid to the Government and the full amount ordinarily regarded as rent or salary income has been taxed, but the Government seeks an additional tax merely because the burden of the income tax has been shifted to the lessee and employer, by an entirely legal and proper contract.

The question decided in the cited cases has never been passed upon by the this Court. The decisions discussing the merits of the question and not merely following precedent, were made before this Court formulated its comprehensive definition of "income" in *Eisner* v. *Macomber*. In two cases there were strong dissents, 216 Fed. 83, and 246 Fed. 625. There is much ground for doubting whether the interest and dividends paid by the lessee to the bondholders and stockholders of the lessor constituted gains drawn or derived by the lessor for its separate use, benefit and disposal within the definition of income in *Eisner* v. *Macomber*.

The Government seeks to use the lessor-lessee cases cited as establishing some general doctrine that an amount paid out by the lessee for the benefit of the lessor, is constructively received by the lessor, and therefore income. *We deny that the income tax payments in question were ever constructively received by the taxpayers, or that such items were income.* The true doctrine of constructive receipt in that income shall be treated as received when the taxpayer has unconditional and unqualified power to reduce such income to immediate possession.

Articles 51 and 52 of Regulations 45.

Ordinarily, such doctrine is important only as determining when a taxpayer reporting on the cash basis must report income. The taxpayers here obviously never had power to reduce the income tax payments to their possession.

In these cases the taxpayers did not, in fact, receive the amount of the income tax paid at the source, and this is an important consideration indicating that such tax is not income. We further maintain that income tax payable at the source, pursuant to a contract, or a statutory obligation, is not commonly regarded as income, whether paid direct to the Collector by the payor, or paid by the taxpayer, who is reimbursed by the payor. The fact that the payor reimburses the taxpayer instead of carrying out his obligation to pay the tax direct, in no way changes the nature of the benefit derived by the taxpayer. The mere fact that in such a case the taxpayer receives the amount of the income tax is not decisive. Not every item received is income. Alimony, life insurance, capital contributions, and return of capital, are not income though actually received.

Gould v. *Gould*, 245 U. S. 151.
United States v. *Supplee-Biddle Hardware Company*, 265 U. S. 189.
Edwards v. *Cuba Railroad*, 268 U. S. 628.
Doyle v. *Mitchell Bros.*, 247 U. S. 179.

The important question in every case is whether the benefit or advantage, or gain, actually derived from a transaction is commonly regarded as income. That question cannot be determined merely by considering whether the taxpayer received certain money, whether constructively or actually.

The lessor-lessee cases cited did not hold that the rent was income to the lessor because it was constructively received. They held that such rent was income to the lessor even though it was not received, or to be received by it, because the lessor derived a gain from the transaction which was normally and usually regarded as income to it. Our position here is that the benefit derived by the taxpayers from receiving rent or salary tax paid is not commonly regarded as yielding any income in excess of the rent or salary received, not because the taxpayer did not actually derive a benefit or advantage, but because the benefit actually derived

under such circumstances is not commonly regarded or usually classed as income. Retaining income undiminished by an income tax is not the same thing as receiving more income.

(f) Principles of construction applicable.

In case of doubt, taxing statutes are construed most strongly against the Government and in favor of the citizen.

Gould v. *Gould,* 245 U. S. 151;
U. S. v. *Merriam,* 263 U. S. 179.

The plain, obvious and rational meaning of a statute is always to be preferred.

Lynch v. *Allworth Stephens Co.,* 267 U. S. 364.

(g) Conclusion.

The question certified should be answered "No".

Respectfully submitted,

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APPENDIX A.

The Statutes.

Revenue Act of 1916 (39 Stat. 756) as amended by Revenue Act of 1917 (40 Stat. 300).

(1) Section 2(*a*) as amended by Section 1200, Revenue Act of 1917:

> "(*a*) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income, derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

(2) Section 9(*c*) as amended by Section 1205, Revenue Act of 1917:

> "(*c*) The amount of the normal tax hereinbefore imposed shall also be deducted and withheld from fixed or determinable annual or periodical gains, profits and income derived from interest upon bonds and mortgages, or deeds of trust or other similar obligations of corporations, joint-stock companies, associations, and insurance companies, (if such bonds, mortgages, or other obligations contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee or to reimburse the obligee for any portion of the tax or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States) whether payable annually or at shorter or longer periods and whether such interest is payable to a non-resident alien individual or

to an individual citizen or resident of the United States, subject to the provisions of the foregoing subdivision (*b*) of this section requiring the tax to be withheld at the source and deducted from annual income and returned and paid to the Government, unless the person entitled to receive such interest shall file with the withholding agent, on or before February first, a signed notice in writing claiming the benefit of an exemption under section seven of this Title."

(3) Section 12(*a*) Fourth, as amended by Section 1207, Revenue Act of 1917:

"Section 12(*a*). In the case of a corporation, joint stock company or association or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources— * * *.

Fourth. Taxes paid within the year imposed by the authority of the United States (except income and excess profits taxes), or of its Territories, or possessions, or any foreign country, or by the authority of any State, county, school district, or municipality, or other taxing subdivision of any State, not including those assessed against local benefits."

Revenue Act of 1918 (40 Stat. 1057).

(1) Section 213(*a*).

"Sec. 213. For the purposes of this title, except as otherwise provided in section 233:

"(*a*) The term 'gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the

ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (*b*) of section 212, any such amounts are to be properly accounted for as of a different period."

(2) Section 214(*a*).

"In computing net income there shall be allowed as deductions: * * *

(3) Taxes paid or accrued within the taxable year imposed (*a*) by the authority of the United States, except income, war-profits and excess-profits taxes; or (*b*) by the authority of any of its possessions, except the amount of income, war-profits and excess-profits taxes allowed as a credit under section 222; or (*c*) by the authority of any State or Territory, or any county, school district, municipality, or other taxing subdivision of any State or Territory, not including those assessed against local benefits of a kind tending to increase the value of the property assessed; or (*d*) in the case of a citizen or resident of the United States, by the authority of any foreign country, except the amount of income, war-profits and excess-profits taxes allowed as a credit under section 222; or (*e*) in the case of a nonresident alien individual, by the authority of any foreign country (except income, war-profits and excess-profits taxes, and taxes assessed against local benefits of a kind tending to increase the value of the property assessed), upon property or business;"

(3) Section 221(*b*).

"(*b*) In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required

or permitted to pay thereon, or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods and whether payable to a nonresident alien individual or to an individual citizen or resident of the United States or to a partnership: PROVIDED, That the Commissioner may authorize such tax to be deducted and withheld in the case of interest upon any such bonds, mortgages, deeds of trust, or other obligations, the owners of which are not known to the withholding agent. Such deduction and withholding shall not be required in the case of a citizen or resident entitled to receive such interest, if he files with the withholding agent on or before February 1 a signed notice in writing claiming the benefit of the credits provided in subdivisions (*c*) and (*d*) of section 216; nor in the case of a nonresident alien individual if so provided for in regulations prescribed by the Commissioner under Section 217.

APPENDIX B.

1917 taxes of Fitchburg Railroad Company based on net income of $1,023,701 and assumed invested capital of $2,000,000. all income taxes payable by the lessee.

I. Applying Taxpayer's Theory.

Net income	$1,023,701.00
Invested capital	2,000,000.00
Excess profits credit (8% of invested capital plus $3,000)	163,000.00

Computation of Excess Profits Tax.

% of Invested Capital		Excess Profits Credit		Rate	Tax
0 to 15%	$300,000	—$163,000	—$137,000	20%	$27,400
15% to 20%	100,000			25%	25,000
20% to 25%	100,000			35%	35,000
25% to 33%	160,000			45%	72,000
Over 33%	363,701			60%	218,220.60
	$1,023,701	Excess Profits Tax			$377,620.60

Income Tax.

Net income	$1,023,701.00	
Less excess profits tax	377,620.60	
Taxable at 6%	$646,080.40	$38,764.82
Total tax		$416,385.42

II. Applying Government's Theory.

(a) *Arithmetical computations.*

*Computation Number	Net Income	Tax	Increase In Tax Added to income for next computation
**1.....	$1,023,701.00	$416,385.42	$416,385.42
2.....	1,440,086.42	676,210.02	259,824.60
3.....	1,699,911.02	838,340.47	162,130.45
4.....	1,862,041.47	939,509.88	101,169.41
5.....	1,963,210.88	1,002,639.59	63,129.71
6.....	2,026,340.59	1,042,032.52	39,392.93
7.....	2,065,733.52	1,066,613.71	24,581.29
8.....	2,090,314.71	1,082,892.38	16,278.67
9.....	2,106,593.38	1,092,076.53	9,184.15
10.....	2,115,777.53	1,097,841.18	5,764.65
11.....	2,121,542.18	1,101,438.32	3,597.14
12.....	2,125,139.32	1,103,692.93	2,254.61
13.....	2,127,393.93	1,105,089.81	1,396.88
14.....	2,128,790.81	1,105,970.87	881.06
15.....	2,129,671.87	1,106,511.25	540.38
16.....	2,130,212.25	1,106,848.44	337.19
17.....	2,130,549.44	1,107,058.85	210.41
18.....	2,130,759.85	1,107,190.15	132.30
19.....	2,130,891.15	1,107,272.08	81.93
20.....	2,130,973.08	1,107,323.20	51.12
21.....	2,131,024.20	1,107,355.10	31.90
22.....	2,131,056.10	1,107,375.01	19.91
23.....	2,131,076.01	1,107,387.42	12.41
24.....	2,131,088.42	1,107,395.17	7.75
25.....	2,131,096.17	1,107,400.01	4.84
26.....	2,131,101.01	1,107,403.03	3.02
27.....	2,131,104.03	1,107,404.92	1.89
28.....	2,131,105.92	1,107,406.09	1.07
29.....	2,131,107.09	1,107,406.82	.73
30.....	2,131,107.82	1,107,407.28	.46
31.....	2,131,108.28	1,107,407.57	.29

* Each computation would require separate computations of excess profits tax and income tax as in computation Number 1.

** Computation Number 1 is the same as taxpayers' computation.

*Computation Number	Net Income	Tax	Increase in Tax Added to Income for next computation
32.....	2,131,108.57	1,107,407.75	.18
33.....	2,131,108.75	1,107,407.86	.11
34.....	2,131,108.86	1,107,407.93	.07
35.....	2,131,108.93	1,107,407.97	.04
36.....	2,131,108.97	1,107,408.00	.03
37.....	2,131,109.00	1,107,408.02	.02
38.....	2,131,109.02	1,107,408.03	.01
39.....	2,131,109.03	1,107,408.04	.01

Net taxable income..... $2,131,109.03
Total Tax..... $1,107,408.04

(b) *Using formula.*

Where it was known that all of the additional income resulting from adding the tax to the income would fall in the highest excess profits tax bracket, the following formula could be used:

Let A = Invested Capital ($2,000,000.).
Let B = Excess profits credit ($163,000.).
Let C = Actual income ($1,023,701.).
Let X = Total tax. Then—

$X = [(.15\ A - B)\ .2 + (.05\ A)\ .25 + (.05\ A)\ .35$ plus $(.08\ A)\ .45 + (C + X - .33\ A)\ .6] + \{C + X - [(.15\ A - B)\ .2 + (.05\ A)\ .25 + (.05\ A)\ .35 + (.05\ A)\ .45 + (C + X - .33\ A)\ .6]\}.06.$

Since A, B and C are known quantities resolving this formula shows that

$.376\ X = \$416,385.42$
$X = \$1,107,408.04$, the total tax.
$\$1,023,701 + X = \$2,131,109.03$, the taxable income.

If the excess profits credit exceeded 15% of the invested capital, as was true in some cases, or it was not known in which bracket the additional income would fall, a more involved formula would be necessary, or a series of arithmetical calculations would have to be made.

* Each computation would require separate computations of excess profits tax and income tax as in computation Number 1.

APPENDIX C.

1918 income tax of individual reporting on accrual basis and receiving a salary of $1,000,000 on which employer paid all income taxes.

A. APPLYING TAXPAYER'S THEORY.

		Tax
Net Income	1,000,000	
Less personal exemption	1,000	
	999,000	
Taxable at 6%	4,000	240
Taxable at 12%	995,000	119,400
Normal tax		119,640
Surtax on $1,000,000 at 1918 rates per Treasury Department Tables		583,510
Total Tax		703,150

B. APPLYING GOVERNMENT'S THEORY.

1. *Computation No. 1,*—based on income of $1,000,000, same as taxpayer's computation of tax, showing tax of $703,150.00.

2. *Computation No. 2,*—based on income of $1,703,150. shows tax of $1,244,575.50.

3. *Computation No. 3* would be based on income of $2,244,575.50 and process would be continued until additional tax was less than half a cent.

4. Since in assumed case, all additional income falls in bracket of over $1,000,000 and is subject to single rate of 77% (12% normal tax and 65% surtax), the total tax under government theory can be obtained as follows:

Total tax = $703,150 + 77% of $\frac{100}{77}$ of $703,150.
Total tax = $3,057,173.91.

Proof—Net Income		4,057,173.91
Tax on $1,000,000	$703,150.	
Tax on $3,057,173.91 at 77%.	2,354,023.91	
Total tax		3,057,173.91
Salary after taxes paid		1,000,000.00

If it was not known that the additional income would all fall in the highest surtax bracket the computation would be more complicated.

APPENDIX D.

Computation 1918 income of lessor, assuming invested capital of $2,000,000, rent of $1,000,000 per annum and applying Government's theory but treating income tax of lessor payable by lessee as accrued income of year when payable.

To find income of lessor in 1918 it is necessary to go back to March 1, 1913 when income tax law started.

1913.

Net Income $1,000,000	
Tax on 10 months income at 1% ..... payable June 15, 1914.	$8,333.33

1914.

Rent	1,000,000.00
1913 income tax	8,333.33
Net Income	1,008,333.33
Tax at 1% ..... payable June 15, 1915.	10,083.33

1915.

Rent	1,000,000.00
1914 income tax	10,083.33
Net Income	1,010,083.33
Tax at 1% ..... payable June 15, 1916.	10,100.83

1916.

Rent	1,000,000.00
1915 income tax	10,100.83
Net Income	1,010,100.83
Tax at 2%	20,202.02

payable June 15, 1917.

1917.

Rent	1,000,000.00
1916 income tax	20,202.02
Net Income	1,020,202.02
Invested capital	2,000,000.00

DEDUCTION.

8% of invested capital	160,000.00
Exemption	3,000.00
Excess profits credit	163,000.00

COMPUTATION OF TAX.

0–15%	$300,000.00—163,000=137,000 at 20%	=	27,400.00
15–20%	100,000.00	25%	= 25,000.00
20–25%	100,000.00	35%	= 35,000.00
25–33%	160,000.00	45%	= 72,000.00
33% up	360,202.02	60%	=216,121.21
	1,020,202.02	Excess profits tax	375,521.21
Net Income		1,020,202.02	
Less excess profits tax		375,521.21	
Taxable at 6%		644,680.81	
Income tax			38,680.85
Total tax for 1917			414,202.06

payable June 15, 1918.

1918.

Rent	1,000,000.00
1917 Income and Excess Profits Tax.....	414,202.06
1918 Income	1,414,202.06

To apply the Government's theory of compounding the tax, on this basis of accruals, it is necessary to go back over a series of years. It is not logically permissible to go back only one year, *i. e.*, in the above case to add to 1918 income only the 1917 tax on $1,000,000 although the tax actually to be paid in 1918 would be at least the tax on $1,020,000, the 1917 rent plus the 1916 primary tax payable in 1917.